2005

Special Allocations and Preferential Distributions in Joint Ventures Involving Taxable and Tax Exempt Entities

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Ohio Northern University
Law Review

Tax Article

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I. OVERVIEW

Joint ventures involving taxable and tax-exempt organizations, referred to in this article as "taxable-tax exempt joint ventures," engender conflict between the doctrinal requirements pertaining to tax exemption and the flexibility afforded joint ventures in Subchapter K.[1] The nonprofit partner must exercise ultimate governing control over the joint venture so that charitable goals take precedence over profit-seeking goals if the nonprofit's share of income is to remain tax exempt. On the other hand, a for-profit partner is entitled and indeed expected to pursue profit but its lack of control over the joint venture exposes the for-profit partner to greater risk of loss than it would confront in other investments. In essence, a for-profit partner in a taxable-tax exempt partnership must assume the role of a limited partner. The nonprofit partner must act as exclusive general partner. In normal partnerships,[2] a limited partner would demand certain risk avoidance or compensation concessions—special allocations, guaranteed payments, and preferred returns —in recognition of the higher risk arising from its lack of control. Those risk avoidance and compensation methods usually have two primary effects. First, they elevate one partner's return potential over those of another. Second, they

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1. Subchapter K means I.R.C. §§ 701–761 (2004).

2. For purposes of this article, the phrase "normal partnership" means any joint venture that does not have a tax exempt partner.

indemnify one partner, to a certain extent, at the expense of another.[3] These effects seem inherently inconsistent with the control mandate, and yet it is unreasonable to think that for-profit partners will participate in taxable-tax exempt joint ventures without insisting on risk avoidance and compensation. This article analyzes the degree to which a taxable-tax exempt partnership or limited liability company can make use of risk avoidance and compensation methods available in Subchapter K without running afoul of doctrinal requirements for tax exemption. The article concludes that the policies underlying tax exemption should prevail over the policies embodied in Subchapter K, but that the Subchapter K policies should nevertheless apply to the extent they are not inconsistent with tax exemption.

II. THE CONTROL MANDATE

Revenue Ruling 2004-51[4] appears to have finally lain to rest the broad theoretical question of whether and by what terms charitable organizations may form partnerships[5] with profit-making entities without forfeiting federal tax exemption.[6] Partnerships involving taxable and tax exempt entities have been discussed and debated for nearly 25 years, beginning most prominently with *Plumstead Theatre Society, Inc. v. Commissioner*[7] in 1980 and continuing through the 1990's and into the new millennium with General Counsel

3. In this article, I will assume that all joint ventures have only two partners or members.

4. Rev. Rul. 2004-51, 2004-22 I.R.B. 974. Revenue Ruling 2004-51 involves an exempt university that forms an LLC with a for-profit entity to provide distance learning via interactive video. *Id.* The operating agreement allows each partner to appoint three members of the governing board but gives the university exclusive control over the educational content of the video classes. *Id.* The ruling concludes that the university's exempt status is not affected by the joint venture because the activities constitute an insubstantial part of the university's activities. *Id.* The ruling further states that the LLC's activities will not generate unrelated business income because (1) the university has exclusive control over the educational content, (2) all contracts entered into by the LLC are at arms length and for fair market value, (3) allocations and distributions are proportional to each partner's ownership interest, (4) the video courses cover the same content as the university's traditional classes, and (6) the video courses increase access to the university's educational programs. *Id.*

5. The term "partnership" refers to any joint venture that is taxed as a partnership and therefore includes limited liability companies that do not elect to be taxed as an association. *See* Treas. Reg. § 301.7701-3(b)(1)(i) (as amended in 2003).

6. It may seem strange that the issue would have consumed nearly twenty five years of intellectual energy given that tax law long ago confirmed that charities do not necessarily forfeit tax exemption when they join together with profit-makers using the corporate form. But there are significant theoretical distinctions between profit making using the corporate form and profit-making via a partnership because a corporation is taxed at the corporate level, while partnerships are not.

7. 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982).

Memoranda 39005[8] and 39862,[9] Revenue Ruling 98-15,[10] *Redlands Surgical Services v. Commissioner,*[11] *St. David's Health Care System v. United States,*[12] and finally Revenue Ruling 2004-51.[13] These seven cases and rulings ("opinions") are briefly synthesized in Section III in order to provide context to the later discussion in Section IV regarding the interaction between partnership tax law and charitable tax exemption. Together, the opinions articulate an explicit mandate that charities may form partnerships with profit-makers without wholly or partially[14] jeopardizing tax exemption only if the partnership agreement gives ultimate control over the partnership to the charitable partner. The best indicators of the required control is the right to appoint a majority of the partnership's governing body, and the articulation of preeminent, legally enforceable charitable goals in the partnership agreement. The mandate was first thoroughly articulated in Revenue Ruling 98-15, but that ruling applied to the more drastic, "whole charity joint ventures,"[15] whereby a charity's entire existence and operation is merged into a partnership.[16] It does not address the less drastic "ancillary joint ventures," by which a charity conducts a smaller part of its operations through a partnership but most of its operations independently.[17] Stakeholders were left wondering whether the same mandate of ultimate control applied in latter instances. Revenue Ruling 2004-51 answers that question in the affirmative, though unlike whole charity joint ventures, *prima facie* control can be demonstrated in ancillary joint ventures even if the charity does not have the right to appoint a majority of the governing board.[18]

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8. Gen. Couns. Mem. 39,005 (June 28, 1983).

9. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

10. Rev. Rul. 98-15, 1998-1 C.B. 718.

11. 113 T.C. 47 (1999), *aff'd,* 242 F.3d 904 (9th Cir. 2001).

12. 349 F.3d 232 (5th Cir. 2003).

13. Rev. Rul. 04-51, 2004-22 I.R.B. 974.

14. The imposition of the unrelated business income tax (UBIT) is a partial withdrawal of tax exemption. *See generally* I.R.C. § 511 (2004).

15. *See* Rev. Rul. 98-15, 1998-1 C.B. 718.

16. The term, "whole hospital joint ventures", is commonly used because joint ventures and most of the relevant rulings were provoked by changes in the health care industry. *See* Darryll K. Jones, *Private Benefit and the Unanswered Questions From Redlands,* 89 TAX NOTES 121, 122 n.9 (2000) (discussing the difference between "whole charity" and "ancillary" joint ventures).

17. *Id.*

18. Rev. Rul. 04-51, 2004-22 I.R.B. 974. Revenue Ruling 2004-51, relating to ancillary joint ventures, adopts the reasoning set forth in an American Bar Association proposal submitted to the Service in August 2002. *See ABA Sends IRS Proposed Revenue Ruling on Ancillary Joint Ventures, available at* LEXIS, 2002 TNT 190-14. ("[T]he only tax risk posed by ancillary joint ventures is that the distributive share of joint venture income may be subject to the unrelated business income tax", and "voting control is not as important in ancillary joint ventures as it is in [whole charity] joint ventures"). I have previously argued, and still assert, that an ancillary joint venture that conveys a private benefit can and should result

Stakeholders have never been happy with the control mandate. They argue, for example, that it is unrealistic to expect a for-profit partner to give control over its profit-making operations to a partner whose goal is something other than profit-making.[19] If that objection is accurate,[20] the control mandate excludes charities from collaborative sources of income that would otherwise be available for good works. Still, the control mandate has survived at least two appellate challenges[21] so there is no reason to think it will be discarded even for pragmatic imperatives such as the need to fund more charity.[22] Stakeholders who are nevertheless dependent upon the benefits that can be obtained only by virtue of a joint venture will simply have to cope with their unhappiness. The one apparent consolation is that the opinions also acknowledge that profit-making via taxable-tax exempt partnerships is not prohibited. That is, the opinions do not suggest that a for-profit partner must be as charitable as the nonprofit partner, nor would it make sense to think so.

Control is necessary, though not absolutely, for the pursuit of profit. One should therefore expect that a profit-making partner would consider the lack

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in the revocation of tax exemption. Darryll K. Jones, *Private Benefit and The Unanswered Questions from Redlands*, 89 TAX NOTES 121, 136–38 (2000). Others assert that the private benefit doctrine is unnecessary, if not irrelevant, and that the worst consequence to a charity whose ancillary joint venture is inconsistent with tax exemption should be that only the income therefrom be taxed. *See* John D. Colombo, *A Framework for Analyzing Exemption and UBIT Effects of Joint Ventures*, 34 EXEMPT ORG. TAX REV. 187 (2001).

19. *See, e.g.*, Todd R. Greenwalt, *Revenue Ruling 98-15: A Critical View*, TAX NOTES TODAY, May 21, 1998, *available at* LEXIS, 98 TNT 98-67 (stating *inter alia* that profit-making hospitals would never subject itself to the control of an unrelated party); Carolyn D. Wright, *Exempt Control Not Absolutely Necessary in Joint Ventures, Kindell Says*, TAX NOTES TODAY, October 31, 2000, *available at* LEXIS, 2000 TNT 211-2 (citing one practitioner as asserting that no for-profit will enter into a joint venture with a nonprofit that insists on retaining control).

20. The reason why the objection may be inaccurate in more than a few instances is that many activities that justify tax exemption can also be quite profitable. A religious publishing house or a famous boys' choir, for example, can generate significant profits whether organized as profit making or charitable. *See, e.g.*, Plumstead Theatre Society, Inc. v. Commissioner, 74 T.C. 1324, 1332 (5th Cir. 2003).

> [T]he line between commercial enterprises which produce and present theatrical performances and nonprofit, tax-exempt organizations that do the same is not always easy to draw. Indeed, the theatre is the most prominent area of the performing arts in which commercial enterprises coexist, often in the same city, with nonprofit, tax-exempt charitable organizations that also sponsor professional presentations.

Id.

21. In both cases, the nonprofit argued that formal control, as manifested by the right to appoint a majority of the governing board, was not absolutely necessary as long as the partnership provided sufficient charitable benefits to the public. *See* St. David's Health Care System v. United States, 349 F.3d 232 (5th Cir. 2003); Redlands Surgical Services v. Comm'r, 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001).

22. Section 502 of the Internal Revenue Code essentially rejects the notion that the pursuit of income by commercial activities deserves tax exemption so long as the funds are devoted to charitable purposes. *See* I.R.C. § 502 (2000).

of control a factor that increases its risk of loss. Agency theory, for example, holds that risk correlates positively with reliance on agents. If risk is too great, the for-profit partner should decline the opportunity to form a partnership. Theoretically, this should be the case in many taxable-tax exempt partnerships because the gist of the control mandate from a for-profit partner's perspective is that it must rely on the charitable partner to conduct its operations and profit must be subordinated to charity.[23] If a well-advised for-profit partner considers the risk significant but not prohibitive, it might enter into the partnership under circumstances that nevertheless decrease the risk arising from its lack of control. Actually, there is nothing unusual about such an approach. In normal partnerships, one or more partners will make concessions allowed by Subchapter K as compensation for another partner's agreement to accept greater risk. Thus, a partnership agreement might authorize disproportionate (i.e., "special") allocations,[24] consistent with the partners' relative economic positions and risk of loss. A partnership agreement might also call for guaranteed payments[25] or preferred returns[26] to compensate a partner whose risk is greater than others, or to induce a partner to forego other

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23. While there are many activities that may be profitably conducted by a tax-exempt entity, *see Plumstead Theatre Soc'y, Inc.*, 74 T.C. at 1332, there are many more others that are unlikely to earn a profit. A drug and alcohol counseling center that serves inner city residents is one example. A single room occupancy (SRO) hotel is another.

24. In this article, I will use the phrase "special allocations" to refer to allocations of income, gain, loss, or deductions that differ by percentage from a partner's percentage of total partnership capital. *See* Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1, 2 (1990) (providing that a system without special allocations is one in which allocations are made in accordance with the relative interest in partnership capital as determined by capital accounts); *see also* JEROLD A. FRIEDLAND, UNDERSTANDING PARTNERSHIP AND LLC TAXATION § 6.04 at 229 (2nd ed. 2003) ("'[S]pecial allocations generally refers to an allocation of a partnership or LLC item that is disproportionate to the partners' or members' capital contributions or to their ratio for sharing other partnership or LLC items.").

25. A "guaranteed payment" is essentially an amount payable to a partner even if the partnership has no net earnings. *See* I.R.C. § 707(c) (2000); Treas. Reg. § 1.707-1(c) (as amended in 1983).

26. A preferred return is a form of special allocation and distribution defined in the tax regulations as "a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain." Treas. Reg. § 1.707-4(a)(2) (as amended in 1992). One writer describes a preferred return with guaranteed payment characteristics:

> Partnership preferred equity is increasingly common. In order to mimic the payoffs of corporate preferred stock, such partnership equity is typically entitled to a preferential return each year payable only out of partnership net income. To the extent there are insufficient partnership profits to pay the preferred return in a given year, the shortfall is carried forward (typically on a compounded basis) and is payable in subsequent years on a preferential basis to the extent there is sufficient partnership income in those years. Finally, upon liquidation, the preferred equity is typically entitled to receive its accrued but unpaid return and liquidation value prior to the partnership common equity receiving any liquidating proceeds.

Lewis R. Steinberg, *Fun and Games with Guaranteed Payments*, 57 TAX LAW. 533, 563 (2004).

investment options. Any one of these methods, and more,[27] is available under Subchapter K as tools to compensate a partner for increased risk.

The opinions by which the control mandate is imposed are generally, though not completely silent on whether the flexibility of Subchapter K applies in all its convoluted glory once the mandate is met. In both revenue rulings, for example, the Internal Revenue Service, (the "Service"), specifically notes, as one factor supporting the legitimacy of the joint venture vis-à-vis the charitable partner, that allocations and distributions to the partners are proportional to each partner's capital contribution.[28] The rulings do not say exactly what effect special allocations and distributions would have, though it is significant that the rulings suggest that special allocations and distributions are inconsistent with tax exemption.[29] The judicial opinions might also be interpreted as assuming, if only implicitly and certainly without actually deciding, that allocations and distributions in taxable-tax exempt partnerships must always be proportional to capital contributions.[30] These observations

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27. A partnership agreement might also obligate one or more partners to contribute more capital at some point via a provision known as a "capital call." One partner could be obligated to indemnify another for unexpected losses.

28. Revenue Ruling 98-15, for example, states only that:

> A [the charity] and B [the for-profit] form a limited liability company, C. A contributes all of its operating assets, including its hospital to C. B also contributes assets to C. In return, A and B receive ownership interests in C proportional and equal in value to their respective contributions.

Rev. Rul. 98-15, 1998-1 C.B. 718.

Revenue Ruling 2004-51 is more explicit, stating:

> M [the charity] and O [the for-profit] each hold a 50 percent ownership interest in L, [an LLC] which is proportionate to the value of their respective capital contributions to L. The governing documents provide that all returns of capital, allocations and distributions shall be made in proportion to the members' respective ownership interests.

Rev. Rul. 04-51, 04-22 I.R.B. 974.

29. My research has found at least two instances where it is asserted that special allocations in taxable-tax exempt partnerships are at least potentially inconsistent with tax exemption. *See* Rochelle Korman & Dahlia Balsam, *Joint Ventures With For-Profits After Revenue Ruling 98-15*, 27 EXEMPT ORG. TAX REV. 441, 443 (2000) (citing Gen. Couns. Mem. 39,732 (May 27, 1988) (for the proposition that special allocations may cause the charitable partner to lose tax exemption); *see also* Michael I. Sanders, *Hot Issues Affecting Partnerships and Joint Ventures Involving Partnerships*, TAX NOTES TODAY, April 20, 1998, *available at* LEXIS, 98 TNT 75-50 (stating that special allocations may be inconsistent with tax exemption, but citing no authority). The authorities cited in both instances do not seem to support the proposition.

30. In *St. David's Health Care Sys. v. United States*, the charity's allegation that all allocations and distributions were proportional to capital contributions went unchallenged and was not an issue because the case was decided on the control issue. *See* Brief for Appellee at 13, St. David's Health Care Sys. v. United States, 349 F.3d 232 (5th Cir. 2003). The partnership agreement in *Redlands Surgical Serv. v. Commissioner*, indicated that the charity was to contribute 27% of the capital yet be allocated 46% of partnership items. Record at Exhibit 17-Q, pg. 5–6, *Redlands Surgical Serv.*, 113 T.C. at 47 (Agreement of General Partnership of Redlands Ambulatory Surgery Center). According to the Court, however,

raise the question whether there is something about charitable tax exemption that should preclude taxable-tax exempt partnerships from access to the same sort of tax flexibility Subchapter K affords to other partnerships.

An obvious concern is that Subchapter K flexibility allows shifting of income and therefore tax avoidance for for-profit partners. The special status afforded charities, however, suggests that charities should not assist in illegitimate tax avoidance, even if the tax avoidance is otherwise available to normal partnerships. The problem is that even intentional tax avoidance under Subchapter K has been specifically condoned by Congress and therefore can hardly be deemed "illegitimate."[31] As a general matter, Congress knowingly tolerates a certain amount of tax avoidance under Subchapter K. The presence of a tax exempt partner increases the opportunity for tax avoidance because income can always be allocated to that partner to decrease one partner's tax liability without increasing any other partner's tax liability. Nevertheless, the tax avoidance made possible by an exempt partner is qualitatively identical to the avoidance specifically condoned by Congress. The question is whether charitable partners should be held to a special, higher standard of conduct with regard to their participation in joint ventures.

A second, less obvious concern is the extent to which the for-profit partner's economic goals necessarily preclude or interfere with the charitable goal by virtue of the risk avoidance or compensation arrangements available under Subchapter K. If earnings from a joint venture must be preferentially channeled to the for-profit partner, the effect might be the same as would occur if the for-profit partner actually controlled the venture. Earnings and profits that would otherwise be used to expand charitable services, according to the charitable partner's desires, might instead be subject to the for-profit's preferential rights. Of course, whenever a charity interacts with for-profits in a commercial setting, the charity and society must expect that the for-profit intends to be enriched by the interaction. It would be illogical to assume that private profit is to be completely prohibited because charities exist within a broader marketplace that is entirely profit-driven.

Section III shows that the joint venture rulings uniformly, and quite correctly, assume that for-profit partners seek profit, not charity, from taxable-tax exempt joint ventures. The rulings implicitly assume that a for-profit

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Redlands actually contributed 37% of the capital and was to be allocated 46 percent of partnership items. *See Redlands Surgical Serv.*, 113 T.C. at 50. In its proposed denial letter to Redlands Surgical Services denying tax exemption, the Service alleged, as one basis for the denial, that allocations lacked substantial economic effect. *See id.* at 70. That allegation was not decided by the Ninth Circuit. In any event, the case involved special allocations but neither the Tax Court nor the Ninth Circuit needed to address the issue because the case was decided on the control issue. *See generally id.*

31. *See generally* Gergen, *supra* note 24, at 4, 8 (noting that special allocations allow for income and character shifting).

partner's expectation of reasonable return is legitimate. Section IV summarizes some of the risk avoidance and compensation methods that partners frequently use to protect their profit expectation and the Subchapter K restrictions that apply to those methods. Section V compares three affirmative legal obligations imposed on charities—the prohibition against private inurement, the prohibition against private benefit, and the public policy doctrine—to the risk compensation methods available under Subchapter K. The goal is to determine whether those risk compensation methods are incompatible with tax exemption. The article concludes that reasonable private gain should not be prohibited, unless the law intends to preclude taxable-tax exempt joint ventures altogether. The risk compensation methods under Subchapter K should therefore be available to taxable-tax exempt partnerships to the extent those methods would be legitimate in the normal marketplace. As noted earlier, the relevant cases and rulings suggest that Subchapter K risk avoidance and compensation methods should be conclusively denied to taxable-tax exempt partnerships. This article explores some of the possible justifications for that suggestion. Section V acknowledges that in particular instances special allocations and preferential distributions undermine the control mandate and should be prohibited, but only as necessary to ensure the charitable goal remains preeminent. This should not require a blanket prohibition but rather a case by case analysis, just as is applied to normal partnerships though for different purposes.

III. THE FOR-PROFIT'S REASONABLY EXPECTED RETURN

Other writers have thoroughly described the doctrinal evolution of taxable-tax exempt partnerships.[32] Those descriptions have quite appropriately focused on what the nonprofit partner should expect and demand from the partnership if the nonprofit is to remain tax exempt. This section recounts that history from a different standpoint. It looks at what the for-profit partner in taxable-tax exempt joint ventures can reasonably expect and legitimately obtain from the joint venture without jeopardizing the nonprofit's tax exemption. The goal is to identify any concessions within the cases and rulings to the axiomatic notion that a for-profit partner is entitled to pursue reasonable profit via its participation in the partnership.

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32. *See, e.g.*, Janet James Mahon, *Joint Ventures Between Non-Profit and For-Profit Organization; St. David's Case – Worthy Destination, But Road Under Construction*, 56 TAX LAW. 845 (2003); Phil Royalty & Donna Steel Flynn, *Not- For- Profit/For- Profit Joint Ventures: A White Paper*, 25 EXEMPT ORG. TAX REV. 37 (1999). I realize the phrase "taxable-tax exempt partnership" may be somewhat oxymoronic. Readers should interpret it to mean a partnership with one or more tax exempt organizations and one or more taxable entities.

The Service held an absolutist view of taxable-tax exempt partnerships prior to the Tax Court's opinion in *Plumstead Theatre Society Inc. v. Commissioner*.[33] That view arose from the doctrinal observation that partners owe one another the highest fiduciary duty.[34] A general partner owes a particularly high duty of fidelity to limited partners since limited partners are even more dependent on a general partner than are other general partners. The logical, yet entirely unimaginative conclusion was that a nonprofit general partner would be required to subordinate its own charitable impulses in favor of its taxable partners' pursuit of profit.[35] Hence, a nonprofit organization could not possibly serve as a general partner in a taxable-tax exempt partnership while still maintaining a tax exemption granted in exchange for an explicit promise to pursue charity rather than profit.[36] It followed from this reasoning that the mere existence of a taxable-tax exempt partnership justified the revocation of the charitable partner's tax exemption.

Plumstead[37] represents not only a specific repudiation of the foregoing logic, but also an implicit recognition that charity and profit-making need not be mutually exclusive. Although the opinion only briefly addresses taxable-tax exempt partnerships,[38] it clearly implies that a for-profit organization can legitimately expect to pursue reasonable profit in its dealings with a tax exempt organization. In hindsight, one can only wonder why this simple

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33. 74 T.C. 1324 (1980).

34. *See generally id.*

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

35. In the early seventies, the Service adhered to the view that:

> By agreeing to serve as the general partner of the proposed housing project, [a tax exempt] Corporation would take on an obligation to further the private financial interests of the limited partners. Since the promotion of those private interests would tend to foster operating and maintenance practices favoring the equity holdings of the limited partners to a greater extent than would otherwise be justifiable on the basis of reasonable financial solvency, the Corporation's assumption of a duty to promote such interests in its capacity as general partner would necessarily create a conflict of interest that is legally incompatible with its being operated exclusively for charitable purposes.

Gen. Couns. Mem. 36,293 (May 30, 1975).

36. *See generally* I.R.C. § 501(c)(3) (2000). "Evidently the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when not conducted for private gain." Trinidad v. Sagrada Orden, 263 U.S. 578, 581 (1924).

37. 74 T.C. 1324 (1980).

38. The court's discussion of taxable-tax exempt joint ventures is confined to a single paragraph on the last page of the opinion. *Plumstead Theatre Soc'y, Inc.*, 74 T.C. at 1333–34. Nevertheless, the very brief discussion laid the foundation for nearly 25 years of debate and analysis. *See generally id.*

theoretical axiom was so painfully derived. Nonprofit organizations exist within the context of capitalism and therefore must enrich profit seekers with whom they necessarily interact to achieve charitable goals.[39] The easiest example involves the payment of reasonable compensation to employees or independent contractors.[40]

Plumstead involved a nonprofit theatre society's efforts to produce a play under tight budget constraints. The society formed a limited partnership with two individuals and a for-profit corporation in an effort to raise needed capital.[41] The Service offered the mere existence of the partnership as proof positive that the society was pursuing profit rather than charity.[42] The Tax Court rejected that notion. In effect, the Court went beyond the blackletter logic regarding fiduciary obligations.[43] The Court noted that the contractual arrangement between the partners was an arm's length transaction supported by reasonable consideration and that the nonprofit partner was not immunizing the for-profit partner against its entrepreneurial risk of loss. Additionally, the Court noted that the for-profit partners had "no control over the way [the nonprofit] operates or manages its affairs[.]"[44] In a footnote, the Court stated that because the joint venture involved only one of many activities undertaken by the nonprofit, the worst that could occur from a tax standpoint had the joint venture not been properly structured is that the earnings from the joint venture would be subject to the unrelated business income tax.[45]

Plumstead rested on the implicit assumption that nonprofits must necessarily convey profit as participants, even if charitable, in the marketplace. Reciting the fact that arms length bargaining resulted in the parties paying reasonable consideration is at least an implicit acknowledgement that the for-profit will and should obtain a reasonable [i.e., market][46] return from its participation in the partnership. Likewise, the Court's citation to the lack of any obligation that the nonprofit indemnify the for-profit partner against entrepreneurial risk implies that the nonprofit's assets should not be used to

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39. *See* Am. Campaign Acad. v. Comm'r, 92 T.C. 1053 (1989) (referring to "secondary benefits" that invariably flow to private profit-seekers when charities pursue their charitable goals).

40. *See generally* BRUCE R. HOPKINS, THE LAW OF TAX EXEMPT ORGANIZATIONS 436 (7th ed. 1998) (discussing charitable organization's right to pay reasonable compensation). The point is relevant only to the observation that exempt organizations usually must pay at least market rate for goods and services.

41. *See Plumstead Theatre Soc'y, Inc.*, 74 T.C. at 1328.

42. *Id.* at 1333–34.

43. *See supra* notes 33–34.

44. *Plumstead Theatre Soc'y, Inc.*, 74 T.C. at 1334.

45. *Id.* at 1334 n.8.

46. *See also* Treas. Reg. § 53.4958-4(b)(1)(ii) (as amended in 2002) (stating, in essence, that reasonable compensation is determined by reference to what the recipient could obtain from the marketplace).

convey more than a reasonable return to the for-profit partner. That is, the return to the for-profit should be no more than what the market would have made available given the risks inherent to the joint venture activity. Capitalist marketplaces do not normally protect an investor from the risk of losing her investment and neither should a nonprofit's tax exempt assets be made available for such purposes. Together, the *Plumstead* factors mandate that a for-profit partner in a taxable-tax exempt partnership should get no more or less than a market rate of return—the same rate of return that a charitable organization would be required to pay for goods or services provided outside the context of a joint venture.

The *Plumstead* factor most directly related to the nonprofit partner's obligation to pursue charity is the requirement that the for-profit have no control over the nonprofit's operations. This factor is relevant to the partnership's overall purpose—that is, whether the nonprofit is operating for a charitable purpose. It does not necessarily preclude a for-profit partner's pursuit of profit since, as noted above, charity and profit need not be mutually exclusive. Control over the venture, then, is a necessary precondition for the exemption of income from a joint venture but it does not preclude the private gain the for-profit partner naturally and necessarily expects.

Plumstead's implications regarding a for-profit partner's pursuit of reasonable profit have been rather thoroughly confirmed by subsequent administrative rulings (both formal and informal) and cases. In a 1983 memorandum, the Treasury Department's General Counsel stated that a taxable-tax exempt partnership did not jeopardize the nonprofit partner's tax exemption so long as the partnership arrangement allowed the nonprofit general partner to pursue charity rather than profit.[47] It is most significant for present purposes that the limited partners involved in the memorandum were entitled to preferential cash distributions on their contributed capital.[48] In a subsequent ruling, the General Counsel objected to a joint venture in part on the grounds that the profit-seeking partner's return was potentially much greater than that available under commercially reasonable terms.[49] Revenue Ruling 98-15, the Service's most authoritative pronouncement on *Plumstead's* view of control, quite explicitly accepts the proposition that the for-profit partner is entitled to earn a profit. The ruling describes two similar fact situations. In the first, the nonprofit partner thoroughly controlled the resulting partnership. In the second,

47. Gen. Couns. Mem. 39,005 (June 28, 1983). General Counsel Memoranda (GCM's) are prepared by the IRS General Counsel. Although made available to the public in redacted form for informational purposes (most accessibly via LEXIS and WESTLAW), GCM's have no precedential authority.

48. *Id.*

49. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

the for-profit partner is granted ultimate control.[50] The first situation is said to demonstrate a taxable-tax exempt partnership that does not cause a revocation of the nonprofit's tax exemption. The second is said to demonstrate a partnership that does cause the revocation of the nonprofit's tax exemption. Significantly, in both situations the for-profit's participation is motivated by and contingent upon a "reasonable rate of return."[51] That the contingency was included in both situations suggests that a taxable entity's pursuit of profit via its participation is rather unremarkable. Indeed, the matter-of-fact manner in which the contingency was stated and then ignored through the rest of the ruling indicates that the for-profit's receipt of a reasonable profit via a partnership with a tax exempt entity is entirely appropriate and to be expected.

The major joint venture cases decided since *Plumstead* likewise confirm the proposition that a for-profit partner may legitimately pursue profit from a taxable-tax exempt partnership. *Redlands Surgical Services,* for example, begins the analysis by stating that a for-profit partner's receipt of "returns on their capital investment" is insufficient by itself to jeopardize the nonprofit partner's tax exemption.[52] Indeed, the opinion acknowledges and accepts the economic inevitability that for-profit partners must be compensated for their participation.[53] The opinion cites the *undue* competitive advantages obtained by the for-profit partner as an important indication that the partnership caused the revocation of the nonprofit's tax exemption. The partnership agreement in *Redlands* contained a non-compete clause that prevented the nonprofit from providing independent services elsewhere in the relevant community.[54] The Tax Court reasoned that this factor would eventually allow the for-profit to operate within the community "with significantly reduced competitive pressures."[55] The economically oriented language suggests that the for-profit was allowed to use the nonprofit's tax exemption to obtain a return greater than

50. Rev. Rul. 98-15, 1998-1 C.B. 718. In Situation 1, the operating agreement also explicitly stated that the LLC must be operated in a charitable manner. *Id.* The LLC entered into a management agreement with a management corporation unrelated to either members. *Id.* In Situation 2, the operating agreement did not make the pursuit of charity the preeminent goal and the management company was a for-profit subsidiary of the for-profit member. *Id.*

51. *Id.*

52. 113 T.C. at 74–75 (citing *Plumstead* for the proposition that "[t]he mere fact that an organization seeking exemption enters into a partnership agreement with private parties that receive returns on their capital investment does not establish that the organization has impermissibly conferred private benefit. The question remains whether the organization has a substantial nonexempt purpose whereby it serves private interests.").

53. *Id.* at 77 ("[F]or the activity is indivisible, and no discrete part of the Operating Partnership's income-producing activities is severable from those activities that produce income to be applied to the [taxable] partners' profit.").

54. *Id.* at 52–53.

55. *Id.* at 92.

would normally have been afforded in the marketplace and, as a result, the partnership jeopardized the nonprofit's tax exempt status. The opinion in *St. David's Health Care System* used similar economic language in describing the unobjectionable features of a taxable-tax exempt partnership that nevertheless caused the revocation of a nonprofit's partner's tax exemption because of a lack of control.[56] The case notes, without apparent concern, that the for-profit partner sought the partnership with the nonprofit as a convenient method by which to expand into a new market.[57]

It may be that this section has devoted too much thought to what really ought to be an obvious point. Profit-making by way of charitable activities, however, is sufficiently alarming to some that the point needs to be reiterated. Often a charity's invariable participation in the broader capitalist marketplace causes stakeholders to question whether tax exemption is appropriate even though the charity is merely complying with general economic laws applicable to all participants and which require the rendition of a fair price for goods and services. Good intentions do not make a charity immune from the marketplace and amoral economic rules are no less applicable between partners. Thus, as the cases and rulings demonstrate, alarm is only appropriately sounded when charitable organizations lend themselves to returns greater than that available to a profit seeker in the normal marketplace. If tax theory condones taxable-tax exempt partnerships, it must also expect and condone that a for-profit partner will receive a market return in exchange for its participation.

IV. RISK COMPENSATION AND TAX AVOIDANCE IN PARTNERSHIPS

In a whole charity joint venture, "control" means that the nonprofit must control the entire partnership if the nonprofit wants to maintain tax exemption.[58] Control must be demonstrated on a prospective basis by provisions in the partnership agreement giving the nonprofit voting control over the joint venture's governing body and making the pursuit of charity the venture's exclusive and preeminent goal. Actual charitable operations will be insufficient to prove a *prima facie* case for exemption in the absence of prospective provisions in the partnership agreement.[59] The control requirement applies as

56. 349 F.3d at 239.

57. *Id.*

58. Rev. Rul. 98-15, 1998-1 C.B. 718. Although Revenue Ruling 98-15 recites several indicia of control (voting control and a provision in the partnership agreement requiring that charitable goals take precedence over profit-seeking goals), it seems clear that voting control on the partnership's governing body is the most important factor. *See* St. David's Health Care Sys., 349 F.3d 232 (5th Cir. 2003) (reversing summary judgment relating to a joint venture that clearly engaged in charitable activities for the foremost reason that the nonprofit did not control the governing body).

59. *See generally Redlands Surgical Servs. v. Comm'r*, 113 T.C. 47, and *St. David's Health Care Sys. v. United States*, 349 F.3d 232, which leave open the theoretical possibility that control might be

well in ancillary joint ventures, though control apparently need not be demonstrated on a prospective basis.[60] Control in ancillary joint ventures can be proven by the manner in which the venture is conducted. In either circumstance, a for-profit partner's lack of control in a taxable-tax exempt joint venture increases the partner's risk of loss.

In normal partnerships, one or more partners may insist upon and be granted concessions related to the undertaking of relatively greater risks.[61] A limited partner, for example, may be entitled to current or cumulative preferred returns. A partner whose capital contribution is qualitatively or quantitatively greater than other partners may be specially allocated items of loss or deduction related to her capital contribution and a partner with specialized knowledge but little capital might be granted a guaranteed payment during the partnership's start-up period.[62] This section briefly describes the tax

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demonstrated by actual operations, and also clearly suggest that the failure to establish control on prospective basis will doom the partnership regardless of the amount of charity actually achieved.

60. Rev. Rul. 2004-51, 2004-22 I.R.B. 1. The nonprofit partner in Revenue Ruling 2004-51 did not have voting control of the governing body but did control the LLC's substantive operations. *Id.* The ruling lends itself to the argument that if the nonprofit organization lacked substantive control, the income from the ancillary joint venture would be taxed as unrelated business income even if the joint venture's actual activities turned out to be both charitable and substantially related to the nonprofit's charitable goals. This would be inconsistent with I.R.C. § 512(c)(1) (2004) which indicates that the income from a partnership is taxable to a nonprofit partner only if the trade or business is actually unrelated. The control criterion is manifestly a prospective standard in the sense that a lack of control suggests that a nonprofit partner is not organized so that it will operate in accordance with charitable goals in the future. This may be logical with regard to whole charity joint ventures but illogical with regard to ancillary joint ventures since, by definition, the majority of the nonprofit's activities are conducted independently of the joint venture. On the other hand, if the nonprofit does not control the ancillary joint venture it also cannot logically be presumed that the partnership's activities will always be related to the nonprofit's charitable goals. Because the organizational requirement is not applicable to the determination of whether UBIT applies, as it is with regard to maintenance of tax exemption, it seems most logical that the lack of control should not automatically result in UBIT. *Compare* I.R.C. § 501(c)(3) (2004) (specifically requiring that a nonprofit be "organized" as well as "operated" in a manner to achieve charitable goals) *with* I.R.C. §§ 511–513 (2004) (together imposing UBIT if a trade or business is unrelated with no mention of an organizational requirement).

61. Gergen, *supra* note 24, at 2 (1990) (stating that partnership allocations allow partners to apportion risk to suit their preferences).

62. The differing economic considerations that influence a partnership agreement are succinctly stated in one of the leading casebooks:

> Through their partnership agreement, partners have considerable latitude to structure allocations of profits and losses (both generally and as to specific income and expense items), the amount and timing of distributions of cash or property, and the compensation paid to partners who render services to the enterprise. The partnership agreement can provide priority returns to partners on their invested capital or for services, and it can specify how much each partner is entitled to receive on a liquidation of the firm. . . . With or without the intrusion of an income tax, a manager partner ordinarily will demand some form of base compensation for her efforts, while the investors may seek a preferred return on their

restrictions, such as they are, on the use of those risk compensation devices. It concludes that the devices are useful and appropriate to legitimately compensate partners for their relative risks. Those same devices, however, lend themselves quite readily to tax avoidance or the undermining of the charitable partner's required control of the joint venture. Section V addresses whether the risk compensation methods allowed to partners under Subchapter K are inconsistent with the theory of tax exemption, and whether the opportunities for tax avoidance are so great that the risk compensation methods available under Subchapter K should be precluded to taxable-tax exempt partnerships.

A capital-poor partner who places her entire livelihood in the hands of others would be best advised to seek a stable and predictable cash flow from those others. For example, if a service partner forsakes her long held career to pursue her fortune with other like-minded but capital-rich partners, she might nevertheless have recurring expenses that cannot be deferred. Such is often the case with service partners in a "money and brains"[63] partnership. The approach is also predictable for a capital-rich partner who commits much of her stored capital to a new partnership. That partner may be capital rich but have low present cash flow and therefore be dependent, now or in the future, on the income that would otherwise be obtained from the capital committed to the partnership. Finally, an investor might have other investment options none of which are inherently more risky than that offered by the partnership. Prospective partners would therefore be compelled to offer the same fixed rate of return to the investor that she could get from the marketplace. The investor would be better off investing in the partnership because in addition to the fixed rate of return, she would be entitled as a bona fide partner to share in the "borrower's" profit. Thus, any capital poor, low cash flow, or option rich partner should seek a fixed and periodic return—a guaranteed payment—as compensation for the peculiar risk caused by its legal inability to control the use of her investment.[64]

> invested capital and an allocation mechanism that provides for a recovery of their investment before profits are shared with the manager partners. If and when the enterprise becomes profitable, the managers usually will insist upon a priority allocation of a stated percentage of net profits . . . with the remaining profits to be shared among all partners in proportion to their capital investments.

STEPHEN A. LIND, STEPHEN SCHWARZ, DANIEL J. LATHROPE, & JOSHUA D. ROSENBERG, FUNDAMENTALS OF PARTNERSHIP TAXATION 112 (5th ed. 1998).

63. *Id.* Professors Lind, et. al., describes a "money and brains" partnership as one in which "investor partners contribute cash and other forms of capital, and manager partners contribute their expertise and entrepreneurial skills." *Id.*

64. Thus, a "guaranteed payment" can be used to insulate a partner against a risk of loss. Gergen, *supra* note 24, at 13.

Preferred returns are another risk compensation technique. As with guaranteed payments, preferred returns might also be used to induce an investor to forego other investment options. Preferred returns give one or more partners the right to be paid an aggregate amount of partnership profits prior to a distribution to other "common" partners.[65] Usually payment is conditioned on whether the partnership actually earns a profit during the accounting period. Thus, preferred returns do not eliminate as much risk as a guaranteed payment, though the distribution preference decreases the amount of time the "preferred" partner's initial investment is subject to risk of loss.

In other situations, partners may structure allocations to accommodate one partner's greater need or preference for present income. Income will therefore be disproportionately allocated to that partner while the need or preference continues, followed by a change to the allocation scheme (a "flip-flop") in later years after the partner has received a certain amount. A flip-flop could be used to provide preferential capital recovery (typically referred to as "payout") to one partner.[66] Flip-flop allocations are more commonly used, however, to accomplish a proportional recovery of capital to each partner.[67] It might also be the case that one partner asserts and is granted a greater entitlement to deductions from property she contributed.[68] This will

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65. *See supra* note 20.

66. For example, a partnership agreement might allocate all profits and losses to one partner until payout, followed by a proportional allocation scheme thereafter.

67. A typical flip-flop is actually more fundamentally correct than any other allocation, at least during the period prior to the change in allocation percentage. For example, a typical flip-flop allocates profits and losses in accordance with each partner's percentage of capital contributed to the partnership until each partner has been allocated an amount equal to her capital contribution. *See, e.g.*, Treas. Reg. § 1.704-1(b)(5), Example 16 (as amended in 2004). Thereafter, profits and losses are allocated equally. This seems fundamentally correct because during the years prior to payout—i.e., recovery of initial capital, one partner bears a greater risk of loss (as measured by initial capital contribution) than another and should be allocated (and distributed) partnership items consistent with that greater risk. Once "payout"—defined as recovery of initial capital—is achieved, the partners bear equal risk and items should be allocated equally. *Id. See also* Hamilton v. United States, 687 F.2d 408 (Ct. Cl. 1982) (approving of a flip-flop allocation consistent with the typical flip-flop described above).

68. The Joint Committee on taxation has described, with apparent approval, a use of flip-flops to prioritize capital recovery:

> [I]n a typical flip-flop, often a large proportion of a newly formed partnership's initial losses and deductions (perhaps 99 percent) flow through to partners with high taxable incomes who can use the tax benefits. This allocation arrangement frequently remains in effect until these partners have recouped their initial investments, and perhaps some additional return, whereupon the allocation shifts so that losses (which are much smaller after the initial years) and profits and distributions (which may have increased if the partnership's business has obtained a firm footing) are allocated in greater proportion to the partners who are tax-exempt, or in a low tax bracket. This type of flip-flop can serve the purpose of giving investors an initial high-ratio writeoff, while keeping a substantial profits interest for the tax-exempt partner.

necessarily result in disproportionate loss allocations though it is possible that aggregate losses allocated to each partner may turn out equal.[69]

Partners may also seek special allocations for obvious tax avoidance purposes. It is not uncommon, for example, that a partnership agreement will contain a "chargeback" provision in conjunction with a prior special allocation of depreciation deductions solely or predominantly to one partner. A chargeback requires that gain from the sale of depreciated property, in an amount equal to prior depreciation deductions, be allocated to the partner to whom the depreciation deductions were specially allocated.[70] The overall result will be that the partner subject to the chargeback will have deferred a portion of her tax liability for the number of years between the first special allocation of depreciation and the year of the chargeback.[71] Finally, gains and losses of a certain character (ordinary or capital) can be allocated to intentionally decrease their aggregate tax liabilities, such as when one partner is tax exempt and another has taxable income from sources unrelated to the partnership.[72] Tax planning, of course, is always legitimate; the incessant problem is distinguishing legitimate tax planning from illegitimate tax avoidance.

Subchapter K recognizes and generously accommodates the economic interests identified above. I.R.C. § 707(c), for example, defines a guaranteed payment as any partnership payment for a partner's services or the use of her capital, if the payment is determined without regard to partnership income.[73] Regulations explain how to account for guaranteed payments but they do not otherwise impose any explicit restriction on their use. Economically, a guaranteed payment is a potentially deductible transfer of capital from one partner to another. In effect, the paying partner places her capital at higher risk than the recipient partner's capital. As such, a guaranteed payment can

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Joint Committee on Taxation, TAX TREATMENT OF MASTER LIMITED PARTNERSHIPS at 37 (JCS-18-87), June 29, 1987.

69. If losses turn out equal to each partner notwithstanding the special allocation, the special allocation will probably violate the substantial economic effect requirement. *See* Treas. Reg. § 1.704-1(b)(2)(iii) (as amended in 2004). The substantial economic effect rules are explained in detail below. *See infra* notes 76–80 and accompanying text.

70. *See* Gergen, *supra* note 24, at 16 (describing, by way of example, a chargeback of the first $100 of net partnership income to offset a prior special allocation of $100 loss).

71. For example, if a two person, start-up partnership has losses during its initial four years of $100 and gain in subsequent four years of $100, an allocation of all losses during the first four years to A, followed by an allocation of all gains in the subsequent years to A to the extent of prior allocated losses (equally thereafter), will result in the deferral of $50 for the first four years. *See id.* If gains in subsequent years are at least equal to prior losses, the allocations will have no affect other than to reduce aggregate tax liabilities.

72. If the partner to whom the losses are allocated is subject to a gain chargeback in later years, the allocations may have no affect other than to reduce taxes.

73. I.R.C. § 707(c) (2004).

be used to indemnify one partner against the partnership's entrepreneurial risks to the extent of the payment.[74] If what is labeled a preferred return is eventually payable in all events,[75] it should instead be treated under I.R.C. § 707(c) as a guaranteed payment since the payment is fixed and is conditional only with respect to time of payment. Tax limitations on guaranteed payments and preferred returns are only implicitly stated. Partnerships will normally avoid unreasonably large guaranteed payments not because of any restriction in Subchapter K, but because the deductibility by the non-recipient partners is conditioned on the payment being viewed as reasonable under I.R.C. § 162.[76] The reasonable requirement is never actually imposed as an absolute matter in Subchapter K, though it makes sense that I.R.C. § 162 would apply if a guaranteed payment is to be treated as though it were being made to an unrelated third party for goods or services.[77]

Preferred returns sometimes require special allocations and thereby trigger the detailed rules that govern special allocations. In a two person, equal partnership, for example, a partner who receives a preferred return will necessarily receive a disproportionate allocation of income if the partnership's total net income is less than twice the amount of the preferred return. If a 50% partner is entitled to the first $100 of distributable cash, and the partnership earns only $150, the preferred partner will receive two-thirds and the common partner one-third of the income. The special allocation will serve as a means to appropriately tax the preferred partner on her disproportionate share of

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74. Guaranteed payments may be amortized over a certain period of time and thereby allow for a partner's gradual recovery of capital.

75. *See* Steinberg, *supra* note 26, at 563.

76. Treas. Reg. § 1.707-1(c) (as amended in 1983) ("For a guaranteed payment to be a partnership deduction, it must meet the same tests under section 162(a) as it would if the payment had been to a person who is not a member of the partnership, and the rules of section 263 (relating to capital expenditure) must be taken into account."). Thus, an unreasonable guaranteed payment would logically be viewed as a disguised distribution of earnings. Treas. Reg. § 1.162-7(b)(1) (as amended in 1958)

> Any amount paid in the form of compensation, but not in fact as the purchase price of services is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock.

Id.

77. For example, if guaranteed payments are "reasonable," they will not be considered as evidence of a disguised sale which would trigger immediate recognition under I.R.C. § 707(a)(2)(A) (2004). Treas. Reg. § 1.707-4 (as amended in 1992). Likewise, reasonable guaranteed payments and preferred returns are excluded in determining whether UBIT applies to nonprofit partners in debt-financed real estate partnerships. Treas. Reg. § 1.514(c)-2(d) (as amended in 2003).

distributed income. I.R.C. § 704(b) attempts to regulate special allocations so that those dictated by the economic bargain between partners are respected while those adopted solely for tax avoidance are disregarded. The essential mandate is that special allocations must have a real, after tax consequence to one or more partners.[78] Greatly simplified, if the effect of a special allocation is merely to reduce the taxes of one or more partners without affecting present or future economic results to any partner, the allocation will be presumed to have been made solely for tax avoidance rather than in pursuit of the partners' economic bargain.[79] Students of Subchapter K will quickly recognize that the word "may" is justified by the various presumptions in the I.R.C. § 704 regulations that permit obvious tax avoidance allocations solely to avoid prohibiting allocations that have legitimate economic motivations, though they result in tax reduction.[80]

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78. Treas. Reg. § 1.704-1(b)(2)(iii)(a) (as amended in 2004). For purposes of space and readability, I endeavor in the text to relate only the essence of the partnership tax provisions related to my thesis without articulating too little information. In the following footnotes, I set forth or paraphrase the very detailed provisions in Subchapter K related to my thesis. Readers familiar with Subchapter K may safely skip those footnotes if they so choose. Readers unfamiliar with Subchapter K can follow the text's reasoning without knowing the details, but may wish to study the footnotes as well.

79. *Id.* The precise requirement is articulated as follows:

> Except as otherwise provided in this paragraph (b)(2)(iii), the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Notwithstanding the preceding sentence, the economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement, (*1*) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.

Treas. Reg. § 1.704-1(b)(2)(iii)(a) (as amended in 2004) (emphasis added).

80. Note that the substantial economic effect test relies on the existence a "strong likelihood" at the time an allocation is placed into a partnership agreement for its effectiveness. That is, it must be reasonably predictable beforehand that an allocation will only not substantially diminish the relative value of any partner's partnership interest compared to the value without the special allocation if it is to be presumed that the allocation is made for tax avoidance purposes. *Id.* Three presumptions apply in determining whether there is in fact a strong likelihood that an allocation is made for tax avoidance. First, if a special allocation in one year does not alter the relative value of any partner's partnership interest from what it would have been without the special allocation, the "strong likelihood will be presumed retroactively and the special allocation will be presumed made for tax avoidance reasons. Treas. Reg. § 1.704-1(b)(2)(iii)(b)(2) (as amended in 2004) (referring to a "shifting allocation"). Second, if the effect of a special allocation is not entirely offset by subsequent allocations made within five years, the "strong likelihood" will be presumed absent and both the original and offsetting allocations will not be presumed made for tax avoidance purposes. Treas. Reg. § 1.704-1(b)(2)(iii)(c)(2) (as amended in 2004) (relating to "transitory" allocations). The third presumption is that the sale of depreciable property will result in neither gain nor

A simple example proves the point and eliminates the need for detailed further discussion of the I.R.C. § 704(b) rules (except in the footnotes). A two member LLC, taxed as a partnership, may have $100,000 and a depreciable building (assume a five year recovery period for simplicity) with an adjusted basis of $100,000. If member A has sufficient outside losses so that her tax liability is zero in each of the next five years, she may agree that all depreciation deductions should be allocated to member B who has no such outside losses. If the LLC agreement also requires that all gain from the later sale of the asset is to be charged back (i.e., allocated) to A to the extent of prior depreciation deductions, and it is a safe reality that the building will not depreciate to the extent of the depreciation deductions, the net effect will be that A will defer taxes but neither partner's economic result will differ from what they would have been in the absence of the special allocation. Although the special allocations seem clearly tax motivated, they are nevertheless permitted under Subchapter K.[81] The special allocation might simply be made in recognition that one partner contributed the wasting asset while the other contributed cash[82] rather than being made for an explicit tax avoidance purpose.

The question for the next section is whether there are any doctrinal or policy matters that preclude taxable-tax exempt partners from utilizing the risk avoidance and compensation methods used in normal partnerships. Certainly there is greater risk, as an economic matter, to a for-profit partner in a taxable-tax exempt partnership because the for-profit partner must submit to the nonprofit's control and charitable endeavors. To a certain degree, the for-profit partner occupies the same status as a limited partner, for whom the risk avoidance and compensation methods are most often utilized. On the other hand, there is greater opportunity for tax avoidance when one partner is exempt from taxes. Tax exemption makes that partner indifferent to special allocations of income or loss.[83] A taxable partner can only accommodate

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loss. *Id.* The "value equals basis" presumption means even if a partnership agreement contains a chargeback provision allocating gain from depreciated property to the partner to whom depreciation deductions were previously allocated, the "strong likelihood" test cannot be met because the partners must assume that sale of the property will result in neither gain nor loss. *Id.* This presumption, more than the others, allows for clear tax avoidance. The example in the text's next paragraph demonstrates this point.

81. The value equals basis presumption prevents there from being a "strong likelihood" that the relative value of B's partnership interests will not vary from what it would have been in the absence of the special allocation. *See* Treas. Reg. § 1.704-1(b)(2)(5), Example 1(ix) (as amended in 2004).

82. *See* Orrisch v. Comm'r, 55 T.C. 395, 402 n.5 (1970) (approving a special allocation in recognition of the partners' differing types of capital contributions).

83. As a final example, a tax exempt partner may be unconcerned that income in any one year is disproportionately allocated to it because the allocation will not be taxed. Thus, a for-profit partner that seeks to defer tax could specially allocate all income in year one to the nonprofit partner and then reverse the allocation of income in a subsequent year. If the offsetting allocation is made more than five years from the initial allocation, the for-profit partner will be presumed innocent. *See* Treas. Reg. § 1.704-1(b)(5),

another taxable partner if she has sufficient outside losses or a peculiar tax status that renders the allocation inconsequential.[84] The greater opportunity for tax avoidance occasioned by a tax exempt partner may therefore require greater vigilance with respect to allocations than is presently required for normal partnerships.

V. SPECIAL ALLOCATIONS, PREFERENTIAL DISTRIBUTIONS AND TAX EXEMPTION

In most specific instances, it is not very difficult to determine whether an entity is entitled to charitable tax exemption. As an overall theoretical matter, though, it is difficult to articulate a universal definition of "charity" deserving of tax exemption.[85] Still, there are a few precisely stated doctrinal requirements.[86] The first requirement is that an entity must be organized and operated primarily for charitable purposes.[87] This requirement is sometimes referred to as the "exclusively operated" requirement.[88] The second requirement is known as the prohibition against private inurement.[89] That prohibition states that a charitable entity may not distribute net earnings to "insiders."[90] Insiders are broadly defined to include directors, officers, and persons having ownership type authority with regard to the charitable organization.[91] The third and least understood requirement is that a charitable entity cannot operate for private benefit.[92] That doctrine essentially requires that the benefits of tax exemption must be broadly dispersed amongst charitable beneficiaries rather than a select group of noncharitable beneficiaries.[93] The unnecessary conveyance of an economic benefit constitutes private benefit. The fourth requirement, one that is only slightly more understandable than the

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Example 8(ii) (as amended in 2004).

84. *See* Rev. Rul. 99-43, 1999-2 C.B. 506 (one partner was insolvent and therefore not taxable on income from the discharge of indebtedness specially allocated to him).

85. *See* Darryll K. Jones, *When Charity Aids Tax Shelters*, 4 FLA. TAX REV. 769, 803–06 (2001) (discussing the elusiveness that characterizes the meaning of "charity" and citing to previous articles attempting to define the term).

86. The specific requirements are either explicitly stated in or extrapolated from I.R.C. § 501(c) (2004).

87. Treas. Reg. § 1.501(c)(3)-1(a)(1) (as amended in 1990).

88. Treas. Reg. § 1.501(c)(3)-1(c)(2) (as amended in 1990).

89. For an in-depth study of the private inurement prohibition, *see* Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. 575 (2000).

90. *Id.* at 578 (citing United Cancer Council v. Comm'r, 165 F.3d 1173, 1176 (7th Cir. 1999)).

91. For an in-depth study of the private benefit doctrine, *see* Darryll K. Jones, *Private Benefit and the Unanswered Questions From Redlands*, 89 TAX NOTES 121 (2000).

92. *Id.*

93. Bob Jones Univ. v. United States, 461 U.S. 574 (1983) (declaring private university undeserving of tax exemption because its racially discriminatory policies conflict clearly defined public policy).

private benefit prohibition, is that a charity must not operate in a manner that is inconsistent with clearly defined public policy.[94] That is, a charity should not cause more societal problems than it solves. These four doctrinal requirements form the legal meaning of "charity" deserving of tax exemption.

This section analyzes whether any of the risk avoidance and compensation methods identified above necessarily violate the doctrinal requirements applicable to tax exempt organizations. The query is prompted by unexplained statements in the two revenue rulings regarding the factors that do not jeopardize a nonprofit partner's tax exemption. Both rulings seem to exclude special allocations though neither ruling, nor any of the cases, provide analytical justification for that possibility.[95] *Plumstead* and subsequent administrative opinions imply that the nonprofit partner may not use its assets to shield a for-profit partner from the joint venture activity's inherent risk of loss.[96] On the other hand, the cases and rulings implicitly accept the notion that a for-profit partner may pursue reasonable profit via the partnership, and that the nonprofit partner must necessarily comply with the rules applicable in the marketplace.[97] Marketplace rules dictate that partners will structure their agreement based on their economic needs and preferences. In joint ventures, one partner may use special allocations or preferential distributions to compensate or indemnify another partner assuming otherwise unacceptable risks. Thus, there are inconsistent implications in the rulings approving taxable-tax exempt joint ventures.

The prohibition against private inurement essentially prohibits a nonprofit organization from overpaying insiders for goods and services.[98] The prohibition is most often implicated when a nonprofit makes payments for services provided by insiders. It also logically applies to loans made to the organization by an insider because a loan is essentially the rental of capital. The prohibition is therefore applicable to guaranteed payments since the

94. *See supra* notes 49–50 and accompanying text.

95. *See supra* notes 51–55 and accompanying text.

96. *Id.*

97. Jones, *supra* note 90, at 595–610 (discussing the history and case law of "strict accounting private inurement").

98. In a whole charity joint venture, all partners clearly stand in a position analogous to "owners" with respect to the nonprofit organization. *Cf. supra* note 88 (defining "insiders" as persons exercising ownership authority over a tax exempt organization). Perhaps an argument could be made that a for-profit partner in a whole charity joint venture should not be deemed an insider because by definition the for-profit partner cannot have the control necessary to be viewed as an owner for purposes of the private inurement prohibition. *See* United Cancer Council v. Comm'r, 165 F.3d 1173, 1176 (7th Cir. 1999) (stating that the ultimate test of insider status is the authority to control the tax exempt organization). The control requirement for insider status, however, seems to be an additional gloss on the regulatory definition which labels an insider any person with a "personal and private interest in the activities of the organization." Treas. Reg. 1.501(a)-1(c) (as amended in 1982).

essence of guaranteed payments is that a recipient partner is acting like an insider selling services or renting capital to the nonprofit organization.[99] Recall too that a guaranteed payment is economically identical to one partner transferring capital to another in exchange for goods or services. In a two-entity taxable-tax exempt joint venture, a guaranteed payment is therefore precisely analogous to a nonprofit partner transferring capital to an insider for goods or services. Thus, even though the effects of guaranteed payments may emulate the effects of special allocations, the propriety of guaranteed payments should be judged, in the first instance, by reference to the prohibition against private inurement. Under this approach, a guaranteed payment to a for-profit partner should jeopardize the nonprofit partner's tax exemption only if the purchase of goods or services from a non-partner insider for the same price would result in private inurement. The proper inquiry is whether the nonprofit partner is transferring profit to the for-profit partner.[100] The analysis focuses solely on whether the guaranteed payment is reasonable by market standards and does not require a blanket prohibition such as might be suggested in the rulings.

Preferred returns are not as easily reconciled with the doctrines applicable to tax exemption. The prohibition against private inurement should apply just as it should apply with respect to guaranteed payment. For example, a preferred return could be structured so that the economic effect is that the nonprofit partner transfers an unreasonable amount of capital to the for-profit recipient partner. In that case, a preferred return would violate a doctrinal requirement for tax exemption.

An additional focus should be on the private benefit doctrine because preferred returns might be viewed as a special and unnecessary benefit accruing to a select, noncharitable beneficiary. The analysis should begin with the recognition that the for-profit partner logically undertakes greater risk than does the nonprofit partner. Under normal marketplace rules, the charitable partner would be obliged to compensate a market participant for her assumption of greater risk. The for-profit is legitimately pursuing profit and is entitled to the same rate of return that would be available in the normal marketplace. The nonprofit is not exempt, by virtue of its good status, from paying market rate for capital. Thus, the nonprofit must offer competitive returns to induce for-profit partners to invest in a charitable joint venture. The for-profit's receipt of a reasonable return is therefore entirely consistent with

99. Recall that a guaranteed payment is deductible, if at all, only to the extent it represents a reasonable payment for goods and services. Treas. Reg. § 1.707-1(c) (as amended in 1958). Moreover, an unreasonable salary paid to an owner is presumptively viewed as a disguised distribution of profit. Treas. Reg. 1.162-7(b)(1) (1958).

100. Rev. Rul. 2004-51, though, implies that the sole consequence would be that the income from the ancillary joint venture would be subject to UBIT.

tax exemption, though that fact was actually confirmed by *Plumstead.* A preferred return should not be viewed as conveying a private benefit to the extent the payment would be necessary outside the context of a joint venture.

The preference inherent in preferred returns complicates the analysis because the for-profit's entitlement may result in the subordination, rather than furtherance, of the charitable goal. Doctrinally, a for-profit partner's entitlement to reasonable returns may legitimately take precedence over all other partnership goals except the accomplishment of the charitable goal. An arrangement that conflicts with this statement should be considered inconsistent with tax exemption. For example, the need to apply surplus funds to charitable operations may suffer because of an unalterable obligation to make a preferred return. That result would be inconsistent with the imperative that charity must take precedence over profit, even reasonable profit, if the nonprofit partner is to retain tax exemption. Sacrificing the charitable goal would suggest that the nonprofit is operated for the profit-making partner's private benefit. The ultimate resolution is probably one that must depend on peculiar facts and circumstances of each joint venture rather than a bright line rule. If the agreement mandates annual distribution of net income with a preference to the for-profit partner, the charitable goal must necessarily suffer if preferred returns are made to the for-profit partner at a time when retained income is necessary to achieve the charitable goal. The requirement to make annual distributions of surplus earnings would necessarily limit the discretion that seems inherent in real control such as that demanded by the control mandate. If distributions are discretionary, though subject to a preference when and if authorized, a preferred return would not necessarily conflict with the requirement that the charitable goal preempt profit-making. This is particularly true with regard to whole charity joint ventures since the nonprofit partner must have voting control of the governing board and can determine when distributions are to be made. In an ancillary joint venture, a nondiscretionary preferred return should likewise be viewed as inconsistent with the requirement that charity take precedence over profit-making since the for-profit's return would have to be made prior to any charitable reinvestment of surplus earnings.[101] Preferred returns, then, are potentially though not necessarily inconsistent with a charitable tax exemption and like guaranteed payments need not be subject to a blanket prohibition.

Perhaps the most troublesome issue relates to special allocations. Special allocations raise concerns in the first instance for the same reason as preferential distributions. If distributions are consistent with allocations, as often they are, a disproportionately large allocation of income to a for-profit partner will have a similar effect as a nondiscretionary preferred return. The charitable

101. *See generally* Jones, *supra* note 85.

goal might suffer as a result of the larger distribution of income to the for-profit partner, particularly if the for-profit partner has no inclination or obligation to reinvest the distribution in the partnership. Thus, special allocations might be viewed as invariably inconsistent with the requirement that charitable goals must predominate.

An even more difficult issue relates to the purposeful use of special allocations for tax avoidance purposes. Loss and depreciation deductions, for example, are useless to a tax exempt partner because the organization pays no taxes. A tax exempt partner is therefore indifferent to the allocation of partnership items. In normal partnerships, one partner will be indifferent only if that partner has outside tax attributes that otherwise eliminate the partner's tax liabilities. A tax exempt partner is not dependent on other losses and deductions, so the opportunity for tax avoidance is heightened in taxable-tax exempt partnerships. If it is assumed that special allocations do not cause the subordination of charitable goals, should special allocations nevertheless be treated as inconsistent with tax exemption if those special allocations assist in the for-profit's tax avoidance plans?

I argue in another article that a nonprofit's intentional lending of its tax exemption for the purpose of tax avoidance should result in the revocation of the nonprofit's tax exemption.[102] The assertion is based on the notion that the private benefit doctrine forbids a nonprofit from unnecessarily conveying a financial advantage on a profit-maker. Doing so results in a waste of public assets; nonprofit organizations constitute public trusts. The lending of a nonprofit's tax exemption asset to a for-profit for tax avoidance purposes—for example, when a nonprofit accepts a disproportionate allocation of income to delay or prevent the taxation of that income to the for-profit partner—can never be necessary because the nonprofit receives no charitable benefit from the transaction.[103] A second asserted justification for denying tax exemption when nonprofits engage in tax avoidance is that the nonprofit is acting in a manner contrary to clearly established public policy. Illegitimate tax avoidance is clearly contrary to public policy, though it is difficult to distinguish illegitimate tax avoidance from legitimate tax planning. Tax exempt organizations are, in sense, entrusted by the tax code with a special fiduciary responsibility to decrease the burdens of government. Tax exempt organizations are manifestly undeserving of tax exemption when instead they increase those burdens by assisting a taxable entity in stealing from the public fisc by way of

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102. Darryll K. Jones, *When Charity Aids Tax Shelters*, 4 FLA. TAX REV. 769 (2001).

103. The sole benefit to the nonprofit organization is the receipt of a fee, disguised or explicit. The pursuit of money, by itself, does not convey a charitable benefit sufficient to warrant tax exemption even if the money is subsequently devoted to charitable activities. I.R.C. § 502 (2004).

illegitimate tax avoidance. Hence, the use of special allocations for tax avoidance purposes is inconsistent with tax exemption.

The problem with these arguments in the present context is that the tax avoidance made possible by special allocations is neither illegitimate nor inconsistent with clearly established public policy. To the contrary, I.R.C. § 704(b) explicitly condones a certain degree of tax avoidance. Thus, a nonprofit might agree to a special allocation motivated by tax avoidance and yet remain perfectly within the law's explicit allowance. Though it can hardly be said that compliance with the law's allowance contravenes public policy, it might still be argued that a nonprofit entity should not engage in tax avoidance even if that avoidance is otherwise condoned. The law so implies in I.R.C. § 514(c)(9)(E), a statute that places limits on special allocations in debt-financed partnerships with tax exempt partners. Those special restrictions are deemed necessary because a tax exempt partner presents special opportunities for tax avoidance.[104] I.R.C. § 514(c)(9)(E) might be viewed, though, as evidence that Congress condones nonprofits' participation in special allocation in circumstances the statute does not cover. This seems especially true since there are no special prohibitions pertaining to nonprofit organizations anywhere else in the Code. These conflicting observations fairly eliminate reliance on grand theory to preclude the use of special allocations in taxable-tax exempt organizations because the theory supports multiple results.

VI. CONCLUSION

The foregoing discussion leads to a conclusion that contradicts the implication in Revenue Rulings 98-15 and 2004-51. There is no invariable inconsistency between special allocations, preferential distributions, and tax exemption. The potential inconsistencies between tax exemption and special allocations and preferential distributions should be addressed as they materialize, not by a prospective rule that entirely prevents partners from using available risk compensation and avoidance methods when economic circumstances dictate. A rule that appropriately indicates that risk compensation and avoidance methods should not result in the subordination of charitable goals to profit-making, along with informative examples, would be sufficient. To completely preclude taxable-tax exempt partnerships from access to those risk compensation methods would ignore two facts upon which taxable-tax exempt joint ventures have been legitimized. First, nonprofit organizations must exist and function within a larger capitalist economy that operates on the basis of profit-seeking; all participants must render fair market value for goods and

104. In addition, the presence of debt multiplies the harm because partners get a higher basis for borrowed money that might never be repaid.

services. Second, for-profit organizations need not become charitable merely because they engage in transactions with nonprofit organizations. They should not be allowed to exploit tax exemption, but for-profit organizations may legitimately seek reasonable returns, assisted by normal risk avoidance and compensation methods, even in their dealings with nonprofit organizations.