



Entrepreneurial Activity of Small Colleges and Universities: UBIT Liability Issues

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Although the focus of UBIT issues has mostly been on large universities, many smaller schools are now looking to commercialize their operations to generate additional revenue.

Unrelated business activities of higher education institutions are coming under increasing scrutiny by the federal government. Currently, IRS regulations allow for the assessment of unrelated business income tax (UBIT) on the non-exempt activities of an exempt institution. Since the 1980s, colleges and universities have begun to capture streams of revenue from: (1) intellectual property rights associated with commercial applications of institutionally generated research, and (2) increasingly, "for profit" making activity at these institutions.

While most of the focus on UBIT issues at higher education institutions has been on technology transfer, joint ventures, and patent licensing (mostly occurring at large universities), there is a significant issue for struggling smaller schools that are looking to commercialize some of their opera-

tions as potential revenue generators, which has received little attention in the exempt organization and tax literature. Smaller schools have increased vulnerability for a few reasons. First, they are less likely to have a complex tax department or counsel with a tax background. Second, many of them are operating on smaller budgets and in the current market are looking to maximize sources of revenue in order to stay viable. Third, the current higher education marketplace has increasingly become muddled with the rise in for-profit institutions and the blending of traditional educational programs with a wider array of nontraditional modes of service delivery.

There has been a significant amount of discussion at the Congressional level regarding whether exempt designation for complex academic en-

terprises is appropriate in today's market. Writing to congressional leaders in March 2016 in defense of tax-exemptions, Harvard President Drew Gilpin Faust opined that tuition fees and grants are insufficient to ensure institutional financial stability.¹ Indeed, a strategy for many leading universities seeking to bolster their financial stability has been to deploy endowment funds to reduce operating costs,² engage in investment activity as a means of generating passive income,³ or commercialize intellectual property assets.⁴ While larger institutions employ offices of technology transfer and intellectual property and tax attorneys on staff to minimize exposure to tax liability, smaller institutions are finding the landscape more difficult to navigate and rife with potential tax pitfalls. The danger for smaller schools seeking to capitalize on potential revenue generating activity is that ill-advised efforts may lead to significant risk exposure, including the assessment of penalties from the IRS and the potential revocation of exempt status.⁵

As the IRS states in the final report of its College and University Compliance Project, "The examinations of college and universities identified some significant issues with respect to both UBI and compensation that may well be present elsewhere across the tax-exempt sector. As a result, the IRS plans to look at UBI reporting more broadly, especially at recurring losses and the allocation of expenses, and to ensure, through education and examinations, that tax-exempt organizations are aware of the importance of using appropriate comparability data when setting compensation."⁶

As damaging as an adjustment to taxable income may be for a larger college, the impact on a smaller college might be even more substantial—particularly as they seek to maximize potential non-tuition revenue streams in order to offset higher op-

erating costs. Such revenue generating exercises include commercializing academic research, producing and licensing a proprietary curriculum for sale to other schools, and providing consulting and technical support services for local businesses. The literature is replete with examples of this kind of activity, which many smaller schools find necessary for their economic survival.

For example, a number of Division III schools have been in the press for their construction of multimillion dollar athletic facilities.⁷ If they follow the lead of other schools and offer community memberships, they might run into potential UBIT issues. Further, when one considers the growing practice of many schools to offer corporate retreats and other professional development programs on campus during the summer to maximize underutilized space, one begins to see some very complicated tax issues emerge.

Setting the issues of fragmented missions and splintered institutional priorities aside, the problem for these schools is once they begin to realize \$2 to \$3 million from aggregate nonexempt activity with a \$30 to \$40 million annual institutional budget, the activity ceases to be de minimis and starts to look like it could potentially endanger exempt status—if their operations are not properly structured to minimize that exposure. While Bok is right that most colleges are not going to see millions of dollars from licensing payments from technology transfer,⁸ it is not that unlikely for them to realize that amount from the cumulative income of six or seven disparate and uncoordinated ancillary

operations that "seemed like a good idea at the time."

This type of venture raises a number of challenges for the nonprofit higher education community. The issues presented include:

- Whether the net aggregate income from for-profit activity at a higher education institution with a modest annual budget might threaten the exempt status of the entire institution.
- Whether the closely held nature and interlocking boards of the college and a for-profit subsidiary might invalidate the protection establishing a subsidiary might provide.

This article will give a brief history and overview of UBIT issues for higher education institutions, discuss the twin issues of potential tax exposure for aggregate operations and the danger of interlocking boards, and offer some suggestions that institutions that seek to recapture potential income from profit making activities might consider in structuring those efforts.

HISTORICAL PERSPECTIVE

American higher education in the twenty-first century is the product of a long history of insulation from legal and governmental intrusion. This deference was in large part extended with the hope that new ideas, innovations, and inventions would result and transform society, adding value to the social and economic enterprise known as contemporary America. Beginning with the Morrill Act of 1862,⁹ the federal government has strongly invested in the development of insti-

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¹ "Unlike for-profit businesses...Harvard and other large research universities rely on a range of sources to ensure financial stability. Tuition alone does not cover the cost of educating a student, and research grants do not cover the full cost of the research enterprise." Letter from Drew Gilpin Faust to Senator Orrin Hatch, 3/31/16. See harvardgazette.files.wordpress.com/2016/04/20160401_harvard_congressional_report.pdf.

² *Id.*

³ For an excellent analysis of UBI issues resulting from such activity, see Reid, "Colleges and Universities: Investing for Impact," 126 JTAX 75 (February 2017).

⁴ See Bok, *Universities in the Marketplace: The Commercialization of Higher Education*, (Princeton University Press, New Ed. edition, 12/5/04).

⁵ 7 IRS's College and University Compliance Project Final Report, dated 5/3/13. The executive summary notes that over 90% of examined colleges had unreported unrelated income subject to tax totaling \$90 million.

⁶ *Id.*, at 6.

⁷ Kelderman, "Small Colleges Sweat Over Sports Facilities," *Chronicle of Higher Education*, 7/11/08.

⁸ Bok, note 4, *supra*.

⁹ Rudolph, *The American College and University: A History* (University of Georgia Press, 1962, 1990).

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tutions of higher education, recognizing that they hold a unique position in the fabric of American culture. This investment has taken the form of both direct support (funding) and indirect support (preferred treatment) by the government. In large part as a result of government support, higher education grew exponentially in the twentieth century. Indeed, the history of American higher education after World War II can be seen as a period of rapid growth unsurpassed by any other culture in any period in history. Fueled largely by an influx of students due to the GI Bill and federal government investment in defense research, higher education as a market segment enjoyed explosive expansion in the late twentieth century.

This expansion was not limited to traditional instructional activities, but also included strong growth in research activity, real estate investment and retail operations, nontraditional programs, and consulting services by higher education faculty and institutions. In this period, higher education transformed from a classical model of ivory towers of education and vocational training centers to the concept of the multiversity:¹⁰ institutions with multiple campuses, multiple missions, and multiple foci. Many of these "multiversities" began to resemble for-profit corporations, as their operations grew from traditional in-

structional programs to multi-layered conglomerates that engaged in teaching, real estate, retail operations, and most notably, scientific research. In a sense, the profit seeking activity of smaller schools in the past decade can be termed the rise of the "mini multiversity." The nature of university scientific research changed as well, reflecting a shift in priorities from basic research to more emphasis on applied research with implications for public policy or business application. This shift, which occurred around 1980, has been termed a new era in higher education research by some commentators.¹¹

A major component of this new era was a rise in the amount of industry-sponsored research, development of university technology transfer programs, and the commodification of research as a marketable asset.¹² This era was also influenced by the ability of universities to patent federally funded research under the Bayh-Dole Act,¹³ which changed the culture of university research in a remarkable way. Universities began to act in an entrepreneurial fashion,¹⁴ courting venture capital, aggressively seeking corporate partnerships through licensing agreements, and developing for-profit subsidiary and start-up firms. In the new multiversity culture, the focus of activity at universities shifted more to the periphery of the

enterprise, resulting in a rise of separately organized research units that largely service interests outside of, and independent to, the central mission of the institution.¹⁵ As this fragmentation occurred, a concurrent and disturbing trend emerged—the potential for tax liability accruing to the university as a result of its profit-seeking activities.

Throughout this period, these institutions continued to enjoy the protections of a government committed to insulating them from the distractions and forces the larger business culture found itself operating in. A reluctance to impute notions of duties owed to students shielded higher education from tort liability and federal tax policy shielded higher education from corporate income taxation. As American higher education is largely considered a nonprofit activity, colleges and universities are extended the special protections nonprofit corporations receive under the Code—they are generally free from paying tax on the income they generate. That protection has a substantial economic value.¹⁶ In the current economic system, this protection is seen by some as an unfair market advantage that ought to be restricted. This is particularly true when the lines have been blurred by the rise in both nontraditional entrepreneurial activity at traditional schools and also in the scope and number of for-profit higher education institutions that are engaged in increasingly similar activity.

The government has taken steps to address this issue by imposing restrictions on higher education institutions. These restrictions often come in the form of UBIT¹⁷ assessed against an exempt higher education institution for its for-profit like activity.

Congress passed UBIT legislation in 1950 to level the playing field between tax-exempt organizations and for-profit enterprises engaged in similar commercial activity. UBIT provides for tax to be assessed against an exempt organization at regular corporate income tax rates if the following conditions are met: the activity must be a trade or business, regularly

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- ¹⁰ "The multiversity, is an inconsistent institution. It is not one community, but several...Its edges are fuzzy...It serves society almost slavishly, a society it also criticizes, sometimes unmercifully...A community, like the medieval communities of masters and students, should have common interests; in the multiversity, they are quite varied, even conflicting. A community should have a soul, a single animating principle; the multiversity has several—some of them quite good, although there is much debate on which souls really deserve salvation." Kerr, *The Uses of the University* (Harvard University Press, 1963).
- ¹¹ Geiger, *Research Universities in a New Era: From the 1980s to the 1990s* (Johns Hopkins, 1993).
- ¹² *Id.*
- ¹³ Bayh-Dole Act of 1980, P.L. 96-517, 12/12/80.
- ¹⁴ Geiger, 1993 at p. 71
- ¹⁵ *Id.*, at p. 75
- ¹⁶ "Currently, the value of the federal exemption and other tax breaks amounts to nearly \$4 billion a year." Blumberg, "From Publish to Perish to Profit or Perish: Revenues from University Technology Transfer and the 501(c)(3) Tax Exemption," *145 University of Pennsylvania Law Review* 89, 92 (November 1996).

- ¹⁷ Section 511.
- ¹⁸ Section 512(a)(1).
- ¹⁹ Harding, *The Tax Law of Colleges and Universities*, 2nd Ed. (Wiley, 2001), p.10.
- ²⁰ Kerr, *The Uses of the University* (Harvard University Press, 1963), note 10, *supra*.
- ²¹ Reg. 1.501(c)(3)-1(a)(1).
- ²² Regs. 1.501(c)(3)-1(b)(1)(i)(a) and (b).
- ²³ "If the results of the research are made available to the public on a non-discriminatory basis...if the research is performed for the United States or other political subdivision...if the research is directed toward benefiting the public." Regs. 1.501(c)(3)-1(d)(5)(iii)(a-c).
- ²⁴ FY07 EO implementing Guidelines, at p. 16. "In 2007, EO will develop a project to review the treatment and allocation of income and expenses in the college and university area. The project is intended to review current practices of calculating unrelated business taxable income, as well as the allocation of income and expenses more generally by and between the organizations (profit and non-profit) comprising large university systems. The project is expected to roll out to the field in 2008."
- ²⁵ FY08 EO Implementing Guidelines, at p. 12.

carried on, and not substantially related to the entity's exempt educational purposes.¹⁸

By adding UBIT provisions to the Code, Congress provided for a mechanism to capture business-like activity that ought to flow to the government treasury without having to revoke an organization's nonprofit status in its entirety.¹⁹ For nonprofit institutions this seems to be a fair deal—find a potentially lucrative income stream, pay corporate tax on the income one receives from that activity, and protect the core exempt status of one's institution. For a traditional large research university, that income, while potentially significant, will likely not, by itself, threaten the university's exempt status. In the era of the multiversity, however, the aggregate number of peripheral operations that flow to the central coffers of the institution might threaten that core exempt status, as the institutional focus begins to come into question. Universities now serve multiple constituencies, and have widely disparate goals, each of which has a fragmenting effect on the central mission of the institution. This is particularly troubling for smaller schools, which have an even tighter, more focused mission than their larger counterparts.

As Clark Kerr stated, which soul of the multiversity deserves salvation?²⁰ Moral issues aside, what are the tax implications for a nonprofit institution of higher education with a significant aggregate amount of for-profit activity? While UBIT allows for the bifurcation of an exempt organization's for-profit and nonprofit activity, it does not preclude revocation of nonprofit status as a remedy. That potential still exists, most notably for entities that engage in a substantial amount of economic activity that is removed from the core principles and purposes of the institution.

WHY ARE ACADEMIC INSTITUTIONS TAX EXEMPT?

Historically, nonprofit organizations are organized under the Code to fulfill one of four roles—religious, charitable, scientific, or educational purposes. In order to qualify for a tax exemption

under Section 501(c)(3), the Code requires that “an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.”²¹ The regulations further require that the organization's incorporating documents:

(a) Limit the purposes of such organization to one or more exempt purposes; and

(b) Do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.²²

Under the Code, an entity established for scientific or educational purposes would qualify for an exemption, as long as any significant activity it undertook was substantially related to the purposes set forth in the organization's incorporating documents.

Academic research operations, therefore, would largely fall under the rubric of exempt activity if the institutional charter reflected a commitment to education or scientific research for the improvement of the American people as some form of public benefit.²³ This is certainly consistent with public policy, as academe was often the only place that would undertake research projects with little to no commercial value, and profitability from educational operations is a relatively new phenomenon. It is part and parcel of the academic enterprise—knowledge deduced solely for its own sake, in an academic institution, with a commitment to furthering the general welfare of the nation. A commitment to advancing the cause of an educated and informed

society is the lynchpin of American higher education. Traditionally, service to the community, teaching, and conducting research are the three central components of the academic enterprise.

The dilemma arises, however, when institutions reach past that commitment and begin to engage in profit seeking activity. This is particularly true in the current market climate of higher education, which includes for-profit educational providers, nonprofit



In the cases of profitable corporations, an allocation of the tax liability among the members of the group may create debtor-creditor relationships among the members

educational providers, and “hybrid” institutions all competing for market share. Given the dynamic nature of this market, there are significant questions raised about the appropriateness of an exempt organization engaging in nonexempt activity and whether that activity should be taxed.

Beginning in 2007, the IRS strongly signaled that unrelated business income (UBI) of exempt organizations was an area of concern. In both the fiscal year (FY) 2007 and FY 2008 Exempt Organization Implementing Guidelines, the IRS indicated that it would be examining compliance with UBIT. In the FY 2007 guidelines, the IRS noted that it would initiate a “College and University Unrelated Business Income Tax Project.”²⁴ In the FY 2008 guidelines, it indicated that it would be engaged in ongoing training for exempt organizations in properly identifying and reporting UBI as well as compliance projects identifying franchise and business venture activity of exempt organization which “[operate] business franchises and [engage] in business ventures with for profit organizations, purportedly for the purposes of furthering their mission or of earning revenues to finance their exempt activities.”²⁵

Indeed the redesign of Form 990, Return of Organization Exempt From Income Tax, includes sections designed to elicit more detailed information regarding the unrelated business activity of an exempt organization.²⁶ The IRS engaged in examinations of some 30 colleges and universities focused specifically on UBI, and conducted a series of educational seminars prior to releasing their final report in May 2013. It is clear that the service has taken and will continue to take a much closer look at this area.

TAXATION OF UBI: AN OVERVIEW

The legal authority for taxing UBI of an exempt organization is found in Section 511.²⁷ UBI is defined as income from a trade or business, regularly carried on by it, that is not substantially related to the charitable, educational, or other purpose that is the basis of the organization's exemption.²⁸ When computing liability for UBI, the IRS considers "the gross income derived by any organization from any unrelated trade or business...regularly carried on by it, less the deductions...which are directly connected with the carrying on of such trade or business..."²⁹ Computation of the tax liability resulting from UBI activity does not treat each revenue seeking activity separately, rather, the IRS considers the aggregate effect of an organization's activities in this area.³⁰

It is well settled law that an institution's foray into nonexempt activities must be limited in scope, any activity that does not further an institution's charitable purposes must be insubstantial in nature.³¹ A commentator has suggested that even a single noncharitable purpose could revoke an organization's exempt status if it is substantial.³²

THE EVOLUTIONARY NATURE OF IRS RULINGS IN THE AREA OF EXEMPT ORGANIZATIONS SEEKING TO PROFIT FROM JOINT VENTURE ACTIVITY

Typically, exempt organizations seek to derive revenue from commercial activity through either teaming with a for-profit partner or establishing a new entity for the purpose of engaging in commercial activity. These types of arrangements can create discomfort for tax professionals. When first confronted with the development of joint ventures between nonprofit organizations and for-profit entities, the IRS position was clear. If a nonprofit organization became involved in a joint venture as a general partner, or shared net profits of a partnership, it ceased to enjoy exempt status.³³

This "per se" position was relaxed a few years later, when the IRS promulgated a "close scrutiny" facts and circumstances test.³⁴ In this case, a nonprofit organization sought to enter into a joint venture with a for-profit pharmaceutical company. The IRS retreated from the "per se" position and stated that there might not be an au-

tomatic conflict between the joint venture activity and the organization's exempt purposes. Instead, the facts and circumstances of the individual arrangement must be parsed to determine if inconsistent duties would exist. This test was further clarified by *Plumstead Theater Society Inc.*³⁵ In *Plumstead*, a local theater group seeking to raise funds organized a limited partnership to produce "First Monday in October" at the Kennedy Center for the Arts. Plumstead was the general partner, and two individuals and a for-profit corporation were limited partners. Under the terms of the arrangement, Plumstead was to receive 36.5% of the profits or losses from the play.

On the basis of this agreement, the IRS denied tax-exempt status to Plumstead Theater Society, reasoning that by engaging in a joint venture with for-profit partners it had a substantial commercial purpose and was operated for the benefit of private, rather than public, interests.³⁶ Plumstead filed suit in Tax Court³⁷ maintaining that it in fact was operating for charitable purposes.³⁸ The court held that the partnership agreement expressly reserved full management control to Plumstead, and therefore was not an impermissible arrangement that would void exempt status.³⁹

After the ruling in *Plumstead*, the IRS advanced a two-prong test when confronted with the issue of a nonprofit/for-profit partnership arrangement. Under the *Plumstead* doctrine, the IRS first looked to whether the organization served a charitable pur-

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²⁶ *Id.*, at pp. 11-12.

²⁷ Section 511, "There is hereby imposed for each taxable year on the unrelated business taxable income [of an exempt organization]...a tax."

²⁸ Section 512 (a)(1).

²⁹ *Id.*

³⁰ IRS Pub. 598, *Tax on Unrelated Business Income of Exempt Organizations* (November 1997). "If an organization regularly carries on two or more unrelated business activities, its unrelated business taxable income is the total of gross income from all such activities less the total allowable deductions attributable to all the activities."

³¹ See *Better Business Bureau of Washington, D.C.*, 326 U.S. 279, 343 AFTR 5 (1945), "the presence of a single ... [non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly ... [exempt] purposes."

³² "A single substantial non-charitable purpose can destroy the tax-exempt status of an organization, regardless of the presence of charitable purposes...if the public benefit derived from the exempt organization's activity bears only a tenuous relationship to its underlying charitable purpose, then the risk of forfeiture of its exempt status is greatly increased." Sanders, *Joint Ventures Involving Tax-Exempt Organizations* (Wiley, 2000), p. 125.

³³ General Counsel Memorandum 36,293 (1975).

³⁴ See General Counsel Memorandum 37,852 (1979), in which the IRS stated that "any partnership or other joint venture arrangement between a [tax exempt organization and a for-profit entity] requires careful scrutiny due to the strong possibility of conflict between the exempt organization's duty to operate exclusively for exempt purposes and any duty it may have to advance the private interests involved in the venture. However, such an arrangement does not per

se preclude exemption under § 501(c)(3)." In Sanders, *Joint Ventures Involving Tax-Exempt Organizations* (Wiley, 2000) p. 121.

³⁵ 675 F.2d 244, 49 AFTR2d 82-1390 (1982).

³⁶ *Id.*

³⁷ 74 TC 1324 (1980).

³⁸ 675 F.2d at 245.

³⁹ *Id.*

⁴⁰ General Counsel Memorandum 39,005 (1982).

⁴¹ Rev. Rul. 69-545, 1969-2 CB 117, "in considering whether a nonprofit hospital is operated to serve a private benefit, the Service will weigh all the relevant facts and circumstances in each case, including the use and control of the hospital. The revenue ruling concludes that the first hospital continues to qualify as an organization described in section 501(c)(3) and the second hospital does not because it is operated for the private

pose. Next, the partnership arrangement itself was reviewed to assure that the exempt organization retained autonomy to act in its own exempt interests.⁴⁰ Provided that there was a finding that the exempt organization was insulated from any conflicting obligations to its for-profit partners, it retained exempt status.

That factor is tremendously significant. Structuring an arrangement in such a way as to insulate the exempt partner from liability on this issue is a key feature of a successful joint venture agreement. There can be no substantial private benefit conferred by the exempt partner upon the for-profit entities or individual partners.⁴¹ Further, a strong showing of activity furthering a legitimate exempt purpose must be shown in order to meet the first prong of the *Plumstead* test.

Higher education institutions can look to numerous IRS rulings and memoranda regarding health care organizations for some guidance here. As Michael Sanders states, "selling pharmaceutical drugs for a profit, as is done by pharmacies, is not charitable, nor is the provision of medical services for a profit."⁴² The doctrine of community benefit still applies. There has to be more than just activity in a traditionally nonprofit area.⁴³ Further, even if a charitable purpose is found, questions arise as to the overall nature of the agreement—specifically the degree of control exercised by the exempt organization over the activities of the newly formed for-profit subsidiary.

THE HEART OF THE MATTER: REV. RUL. 98-15, REDLANDS, AND THEIR APPLICABILITY TO JOINT VENTURE/COMMERCIAL ACTIVITY OF EXEMPT HIGHER EDUCATION INSTITUTIONS

On 3/23/98, the IRS released Rev. Rul. 98-15,⁴⁴ discussing the formation of a joint venture between a health care organization and a for-profit entity.⁴⁵ Rev. Rul. 98-15 provides an in-depth analysis of the IRS position regarding nonprofit, for-profit partnerships.⁴⁶ This is perhaps the single most important ruling with respect to higher education institutions that choose to engage in joint venture activity with for-profit entities or create a for-profit subsidiary.⁴⁷

The joint venture presented in this ruling, organized as a limited liability company (LLC) resulted in the creation of a hospital. Two possible scenarios for the structure of the LLC are presented. In both, the nonprofit entity contributes all of its assets to the LLC, and receives an ownership interest in return. This interest is proportional to the amount contributed. The funds received by the nonprofit as its percentage of ownership are intended to further its charitable purpose.⁴⁸

The scenarios differ, however, in the following areas: (1) control through board composition; (2) overriding fiduciary duty; (3) management contract; (4) related versus independent officers; (5) conflicts of interest; (6) minimum distributions; and (7) reserved powers.⁴⁹ These differences shape the broad outline that guides current IRS practice in the current era

of analyzing joint venture activity of exempt and for-profit entities.

In situation one, the LLC operating agreement allows the nonprofit to appoint three of the five board members. The board members appointed by the nonprofit are independent of the hospital and are disinterested (no business dealings, conflicts, etc.) The agreement requires major decisions to be ratified by a three vote majority. Further, the agreement requires that "in the event of a conflict between operation in accordance with the community benefit standard and any duty to maximize profits, the members of the governing board are to satisfy the community benefit standard without regard to the consequences for maximizing profitability."⁵⁰ Finally, the agreement allows for the appointment of a management company unrelated to either partner, which has day-to-day responsibility for the affairs of the LLC, and can be terminated for cause by the board of the LLC. The nonprofit entity plans to use its share of revenues to fund charitable activities. After reviewing the facts and circumstances of the case, Rev. Rul. 98-15 indicates that the IRS would consider the agreement structure sufficient to insulate the nonprofit from for-profit activity and would treat the nonprofit partner as an organization continuing to serve a primary charitable purpose.⁵¹

Situation two, by comparison, is more muddled. In this example, the nonprofit entity and for-profit partner have equal decision making rights in the joint venture LLC. Further, the

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benefit of the physicians who control the hospital." Cite in Rev. Rul. 98-15.

⁴² Sanders (2000), p. 127.

⁴³ "While the diagnosis and cure of disease are indeed purposes that may furnish the foundation for characterizing the activity as 'charitable,' something more is required." *Sonora Community Hospital*, 46 TC 519 (1966).

⁴⁴ 1998-1 CB 718.

⁴⁵ "Although this ruling was long awaited in the health-care area, the IRS has stated that its guidelines can be applied to joint ventures between non-profits and for-profit organizations in other areas." Sanders (2000) p. 135.

⁴⁶ "A section 501(c)(3) organization may form and participate in a partnership, including an LLC treated as a partnership for federal income tax purposes, and meet the operational test if participation in the

partnership furthers a charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners. See *Plumstead* and *Housing Pioneers*. Similarly, a section 501(c)(3) organization may enter into a management contract with a private party giving that party authority to conduct activities on behalf of the organization and direct the use of the organization's assets provided that the organization retains ultimate authority over the assets and activities being managed and the terms and conditions of the contract are reasonable, including reasonable compensation and a reasonable term. See *Broadway Theatre League*. However, if a private party is allowed to control or use the nonprofit organization's activities or assets for the benefit of the private party, and the benefit is not incidental to the accomplishment of exempt purposes,

the organization will fail to be organized and operated exclusively for exempt purposes." Rev. Rul. 98-15 at pp. 17-18.

⁴⁷ "In early 1998, the IRS issued a major ruling setting forth guidelines on the extent to which a tax-exempt organization can enter into a partnership with a for-profit entity. This ruling requires the tax-exempt organization to be in control of the partnership, and failure to do so can result in loss of the organization's section 501(c)(3) status on the ground that it is operating for the private interest of the for-profit partner and not exclusively for exempt purposes." Harding, Bertrand, *The Tax Law of Colleges and Universities* (Wiley, 2001) p. 78.

⁴⁸ Rev. Rul. 98-15 at pp. 17-18.

⁴⁹ *Id.*

⁵⁰ *Id.* at 3.

⁵¹ *Id.* at 20.

nonprofit agrees to approve the selection of two former employees of the for-profit partner to serve as the LLC management team. There will be some question as to the primary mission of the joint venture, as the approval of at least one board member appointed by the for-profit partner will be needed on any board decision. As to day-to-day management issues, they will be determined by individuals who have a strong tie to the for-profit partner.

After reviewing the facts and circumstances of the case, Rev. Rul. 98-15 indicates that the IRS would consider this agreement structure insufficient to insulate the nonprofit from for-profit activity and would treat the nonprofit partner as a for-profit entity.⁵² While the Revenue Ruling offers strong insights into IRS policy in this area, the ruling has yet to be extended to the higher education setting. One commentator has suggested that this process will continue to evolve over time, as open issues are resolved on a case by case basis.⁵³ It is somewhat clear, however, that a major factor the IRS will consider is the degree of daily control exerted over the joint venture enterprise.⁵⁴ One commentator notes that in instances where control is an issue but the facts fall short of complete revocation, IRS officials have expressed clear intent to treat income from the venture as UBIT. There is an open question as to how broad this treatment might reach.⁵⁵ Another commentator indi-

cates that Rev. Rul. 98-15 has direct application to this issue in the context of ancillary joint venture activity in the healthcare area.⁵⁶

This issue was litigated in the Tax Court in *Redlands Surgical Services*.⁵⁷

In *Redlands*, Redlands Surgical Services (RSS), a nonprofit corporation, was a wholly owned subsidiary of Redlands Health Systems, Inc. (RHS), also a nonprofit corporation. RHS entered into a joint-venture agreement with SCA Surgery Centers (SCA) a for-profit corporation. In the agreement, RHS and SCA had joint decision-making authority. Soon after, RHS transferred all interest in the partnership to RSS. The IRS revoked RSS' exempt status on the theory that RSS was operated for the benefit of private parties and not exclusively for charitable purpose.⁵⁸ RSS appealed on the grounds that its activities met the operational test and were valid under the integral part doctrine. The Tax Court upheld the IRS denial of exempt status, ruling that RSS had in fact ceded effective control of the partnerships' and the Surgery Center's activities to for-profit parties, conferring on them significant private benefits, and therefore was not operated exclusively for charitable purposes within the meaning of Section 501(c)(3).⁵⁹ The Appellate Court affirmed.⁶⁰

In *Redlands*, the court focused on the totality of the facts and circumstances in the RSS agreement, determining that issues of control, lack of

a primary charitable purpose trumping any fiduciary interest owed to the for-profit partners, and management provisions tailored toward maximizing profits were significant factors weighing toward revoking exempt status.⁶¹ The revocation, however, did not extend to RHS. In other words, the subsidiary organization lost its exempt status, but the parent did not. Clearly, there are advantages to an exempt organization for creating an intermediary entity to participate in a joint venture with a for-profit partner.

Applying Rev. Rul. 98-15 and *Redlands* to the academic context, it is no surprise that start-up company formation and joint venture activity would concern institutional policy makers and create a new wave of intermediary organizations designed to insulate the multiversity from the risk of losing exempt status.

THE CURRENT STATE OF AFFAIRS: USE OF A FOR-PROFIT SUBSIDIARY AS AN INTERMEDIATE ENTITY, REV. RUL. 2004-51, AND CURRENT IRS THINKING IN REGARD TO UBIT

After Rev. Rul. 98-15 and *Redlands*, the landscape of current IRS thinking in the joint venture area has taken shape. There are severe dangers and significant consequences to engaging in a venture without careful consideration of the manner in which an entity approaches the arrangement. One com-

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⁵² *Id.* at 23.

⁵³ Sanders (2000) p. 137.

⁵⁴ "You really need to look at who is going to be making the day-to-day decisions, who is going to be deciding how the money is spent, who is hired, fired, how and why," Marcus Owens, Director IRS Exempt Organizations Division, as reported in 24 *Exempt Organizations Tax Review* 463, June 1999.

⁵⁵ "IRS officials have stated in public presentations that where the partnership arrangement with the for-profit entity violates the 'control' requirements, but the facts are insufficient to support revocation of an organization's section 501(c)(3) status, the IRS will treat the partnership distribution as unrelated business income. It is unclear how the IRS plans to coordinate any such positions with the statutory rules of section 512(c). In other words, if a university enters into a partnership with a for-profit entity to conduct an activity that is conducted by the university itself would be a related activity...but the university is not in control of the part-

nership, will the IRS treat any partnership income as unrelated business income?" Harding (2001) p. 78.

⁵⁶ Sullivan, "Unrelated Business Income: Recent Developments Planning Strategies for Multi-Corporate Entities, and Selected Health Care Issues," *Exempt Organization Tax Review* 22 (Dec. 1998), in Sanders, (2000).

⁵⁷ 242 F.3d 904 (Review Denied 2001), 113 TC 37 (1999).

⁵⁸ Sanders, (2000) pp. 139-142.

⁵⁹ 113 TC 47 at 78.

⁶⁰ "Specifically, we adopt the tax court's holding that appellant Redlands Surgical Services has ceded effective control over the operations of the partnerships and the surgery center to private parties, conferring impermissible private benefit. [Redlands Surgical Services] is therefore not operated exclusively for exempt purposes within the meaning of sec. 501(c)(3). I.R.C. 1986. We also affirm the tax court's conclusion that the benefit conferred on private parties by the surgery center's operations prevents Redlands Surgical Serv-

ices from attaining tax exempt status under the integral part doctrine." 242 F.3d 904 at 904-905.

⁶¹ See also *St. David's Health Care System*, 349 F.3d 232, 92 AFTR2d 2003-6865, 236-237 (CA-5, 2003), which "held that the determination of whether a nonprofit organization that enters into a partnership operates exclusively for exempt purposes is not limited to whether the partnership provides some (or even an extensive amount of) charitable services. The nonprofit partner also must have the capacity to ensure that the partnership's operations further charitable purposes." *Id.* at 243. [T]he non-profit should lose its tax-exempt status if it cedes control to the for-profit entity. *Id.* at 239." *Cited in* Rev. Rul. 2004-51.

⁶² "EOs considering joint ventures with for-profit entities will have to compare their proposed arrangements with *Redlands* and try to avoid the trouble spots highlighted by the Tax Court. The sense that private, commercial goals were overriding was fatal in *Redlands*, and it behooves the parties to any new arrangements to avoid similar circumstances." Flynn, "Tax Court's

mentator has suggested that the structure of the enterprise is key.⁶² One clear way to structure a venture and avoid revocation would be through the use of a for-profit subsidiary organization. By using a properly structured subsidiary, an exempt organization can indirectly be involved in a for-profit activity without jeopardizing the parent's exempt status.⁶³ The IRS has taken a position on this type of arrangement, which tends to endorse the practice.⁶⁴ There are, however, some important caveats to be considered by an exempt organization in adopting this practice. On 6/1/04, the IRS released Rev. Rul. 2004-51,⁶⁵ which addressed some of these concerns.

Rev. Rul. 2004-51 posed the following questions:

1. Whether, under the facts described below, an organization continues to qualify for exemption from federal income tax as an organization described in Section 501(c)(3) when it contributes a portion of its assets to and conducts a portion of its activities through an LLC formed with a for-profit corporation.
2. Whether, under the same facts, the organization is subject to UBIT under Section 511 on its distributive share of the LLC's income.

In the hypothetical, M, a university classified as exempt under Section 501(c)(3) as an educational institution, offers summer seminars to elementary and secondary school teachers. M forms a joint venture with O (a for-

profit company specializing in interactive video training programs) to create L, a domestic LLC. The operating charter states that the sole purpose of L is to offer teacher training seminars at off-campus locations using interactive video technology. M and O each hold a 50% ownership interest in L, which is proportionate to the value of their respective capital contributions to L.⁶⁶ While M and O each appoint three of the partnerships' six directors, M retains control over a significant portion of L's operations, including the approval of curriculum, training materials, and instructors.⁶⁷

The hypothetical clearly states that M's involvement in L will be an insubstantial part of M's activities within the meaning of Section 501(c)(3) and that given the nature of the agreement M would both retain its exempt status and not be subject to UBIT.⁶⁸ However, the ruling also cautions that M may be liable for UBIT if L conducts a trade or business that is not substantially related to the exercise or performance of M's exempt purposes or functions.⁶⁹

Rev. Rul. 2004-51 offers important insights into the extension of principles of UBIT in the higher education context. However, there are several unresolved questions, such as when a subsidiary's activity might become substantial, or what activity might be construed as not being substantially related to the exempt parent's educational purposes. Current IRS thinking

in this area suggests that the following questions are significant factors in evaluating the facts and circumstances of an arrangement to determine the impact of a subsidiary on a nonprofit parent's exempt status.

The Subsidiary Must be Organized as a "Separate Legal Entity"

The IRS has taken a position that if the subsidiary seems to be acting as a "mere instrumentality" of the parent and does not have an independent basis for existing, the activity of the subsidiary might pass through to the parent and threaten its exempt status.⁷⁰ There are two factors the IRS considers, whether the subsidiary is organized for a bona fide business purpose, and the degree of involvement of the partner in the affairs of the subsidiary.⁷¹

It is not enough to establish a subsidiary as a separate legal entity, if the subsidiary performs essentially the same function as the parent organization. If there is not some greater business purpose to the subsidiary, the IRS will treat them as the same entity. In doing so, it will look to the actual substance of what the subsidiary does, and not simply the form it is held in.⁷²

The Entity Cannot be a Mere "Arm" of the Parent

The subsidiary must not, in reality, be a mere arm, agent, instrumentality, or integral part of the parent.⁷³ The instrumentality theory of contract law

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Decision in *Redlands* Provides Limited Endorsement for IRS Position on Joint Ventures" 91 JTAX 241 (October 1999).

⁶³ Sanders, (2000) p. 157.

⁶⁴ "...Because the expanded activities could be viewed as noncharitable, the exempt organization formed a wholly owned subsidiary to the IRS for for-profit entities. Thus, the exempt organization segregated the taxable activities so as not to jeopardize its tax-exempt status." See General Counsel Memorandum 39.326 (1985).

⁶⁵ 2004-22 IRB 974.

⁶⁶ *Id.*

⁶⁷ *Id.* "The governing documents provide that L will be managed by a governing board comprised of three directors chosen by M and three directors chosen by O. Under the governing documents, L will arrange and conduct all aspects of the video teacher training seminars, including advertising, enrolling participants, arranging for the necessary facilities, distributing the course materials and broadcasting the seminars to various locations. L's teacher training seminars will cover

the same content covered in the seminars M conducts on M's campus. However, school teachers will participate through an interactive video link at various locations rather than in person. The governing documents grant M the exclusive right to approve the curriculum, training materials, and instructors, and to determine the standards for successful completion of the seminars. The governing documents grant O the exclusive right to select the locations where participants can receive a video link to the seminars and to approve other personnel (such as camera operators) necessary to conduct the video teacher training seminars. All other actions require the mutual consent of M and O."

⁶⁸ *Id.* "L's activities have expanded the reach of M's teacher training seminars, for example, to individuals who otherwise could not be accommodated at, or conveniently travel to, M's campus. Therefore, the manner in which L conducts the teacher training seminars contributes importantly to the accomplishment of M's educational purposes, and the activities of L are substantially related to M's educational purposes. Section 1.513-1(d)(2). Accordingly, based on all the facts and circumstances, M

is not subject to unrelated business income tax under § 511 on its distributive share of L's income."

⁶⁹ *Id.* "The activities M is treated as conducting through L are not a substantial part of M's activities within the meaning of § 501(c)(3) and § 1.501(c)(3)-1(c)(1). Therefore, based on all the facts and circumstances, M's participation in L, taken alone, will not affect M's continued qualification for exemption as an organization described in § 501(c)(3). Although M continues to qualify as an exempt organization described in § 501(c)(3), M may be subject to unrelated business income tax under § 511 if L conducts a trade or business that is not substantially related to the exercise or performance of M's exempt purposes or functions."

⁷⁰ General Counsel Memorandum 39.598 (1987).

⁷¹ Sanders, (2000) p. 158.

⁷² "...the determination as to the existence of a business purpose was an appropriate test for requiring substance over form given the factual circumstances of the particular case." General Counsel Memorandum 39.598 (1987).

⁷³ Sanders, (2000) p. 160.

has application here. If the entity is seen to simply be a fiction established to shield the parent from liability, the court will pierce the corporate form and impute liability to the parent.⁷⁴ The standard for doing so, however, is clear and convincing evidence of the subsidiary's lack of autonomy.⁷⁵ In order for there to be a finding that liability should pass through to the parent, the parent has to be shown to be actively engaged in the day to day operation of the subsidiary, and the actual purpose for which the subsidiary is organized must be shown to be that which the parent might normally undertake.⁷⁶

The "Control" Issue has Broad Implications for Taxable Status

In analyzing a parent-subsidiary situation, the key question is the degree of control the parent exerts. In the case of a for-profit subsidiary, that is easily determined by the percentage of the parent's ownership in the subsidiary. If greater than 50%, control is assumed. If less than 50%, control might still be imputed if the minority interests are insufficient to override the parent's will.⁷⁷ Regardless of the percentage, once control by the parent is established, the amount of interest, annuities, royalties, and rents received by the controlling parent from the controlled subsidiary becomes UBIT to the parent if the subsidiary's actions are determined to be unrelated to the parent's exempt activity.⁷⁸ While Rev. Rul. 2004-51 left the question of revocation unresolved, it remains a significant concern that if the unrelated activity of controlled subsidiaries rises to the level of substantiality it is possible that exempt status could be lost.

SUGGESTIONS FOR COLLEGES TO CONSIDER

The fact remains, however, that many institutions will continue to seek out and attempt to profit from commercializing assets or expertise that they possess. There is some merit to this, as it can be economically efficient to maximize underutilized assets and also can often lead to stronger institutional fiscal health. However, there are some dangers as well. The significant tax exposure that institutions engaging in profit seeking activity have has been discussed above. It is imperative that any school seeking to engage in profit-seeking activity consult with sophisticated tax counsel prior to engaging in such activity. It is a long-standing truth that the Code can be a trap for the unwary, and schools that do not generally retain the services of a tax specialist would be well served to do so.

While by no means an exhaustive list, below are some points that a college should consider when contemplating profit seeking activity or commercialization of institutional assets.

Does the Proposed Effort Fragment the Institution's Mission?

This is important both from a tax perspective and a moral one. On the tax side, if the effort is found to be removed from the purposes of the institution and in the aggregate enough efforts are being undertaken, exempt status could be jeopardized.

As a moral issue, if institutional priorities stray from the college's core mission, it becomes difficult to classify and manage. These types of issues often lead to acrimony and institutional discord, which may make the revenue

derived from the activity bitter fruit from a poisoned tree.

Has the Institution Engaged the Services of Competent Tax Counsel to Ensure That it is Protected From Liability?

The institution that chooses to engage in profit seeking activity needs to utilize the services of competent tax counsel. At larger schools, there is often a tax specialist (or a department of tax specialists) on staff who keep abreast of current trends in tax law and keep the institution out of trouble. Smaller schools may not have that luxury, and frequently employ legal counsel and accounting professionals who are generalists. It is imperative that the institution which seeks to venture into this area understand the ramifications of this activity.

Are the Arrangements Structured in Such a Way as to Avoid Issues of Separation, Instrumentality, and Control?

As stated above, the danger of improperly structuring a joint venture or subsidiary arrangement is the risk that the arrangement can negatively affect exempt status. This is a complex area of law with shifting guidance available from the IRS, and it is imperative that an institution that seeks to engage in such activity have up-to-date advisement in regard to structural concerns. Competent counsel can work to minimize that risk by properly structuring arrangements to comport with current tax law.

Does the Institution Have an Accurate Picture of the Cumulative Efforts of Commercial Activity in Which it is Engaged?

The danger of engaging in commercial activity in a complex enterprise is that very often it is difficult to accurately gauge the cumulative effect of what is happening. At larger institutions, departments exist to monitor activity and report on the effects of those efforts. At smaller schools, there likely is not a similar effort in place. Typically, an institutional CFO or Vice President for Administration will be

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⁷⁴ "The rationale for holding the dominant corporation liable for the subservient corporation's debts is that, since the dominant corporation has misused the subservient corporation's corporate form by using it for the dominant corporation's own purposes, the debts of the subservient corporation are in reality the obligations of the dominant corporation." *Krivo Industries Supply Co. v. National Distiller & Chem. Corp.*, 438 F.2d 1098, 1101 (CA-5, 1973).

⁷⁵ Sanders, (2000) p. 160.

⁷⁶ *Id.*

⁷⁷ Harding, (2001), p. 265.

⁷⁸ Sanders, (2000) p. 164; Rev. Rul. 2004-51.

⁷⁹ Bok, note 4, *supra*.

⁸⁰ "The Internal Revenue Service issued final regulations on Thursday that could force colleges to begin paying taxes on some exclusive partnerships that they have forged with athletic gear manufacturers, soft drink companies and other businesses." Hebel, "New IRS Regulations Could Force Colleges to Pay Tax on Some Partnership Deals," *Chronicle of Higher Education*, 4/26/02.

⁸¹ Bok, note 4, *supra*.

⁸² *Id.*, at pp. 17-18.

responsible for keeping tabs on these activities. This individual (and his or her department) will very likely already be stretched thin.

The institution that is contemplating engaging in commercialization would be well served to audit existing efforts and develop a system for managing these efforts. At a minimum, there should be a clear chain of command and reporting mechanism where efforts to maximize revenues are monitored by a single department.

Does the Institution Have a System in Place to Monitor These Revenue Generating Efforts and Consider Both Their Feasibility and the Potential Effect They May Have on Institutional Finances?

While performing an initial audit of programs is necessary, having an ongoing system of monitoring and performance measurement is also vital. As Bok stated, most colleges are not going to see financial windfalls from this activity.⁷⁹ Very often, a well intentioned effort will result in a financial drain on the institution, which draws personnel and resources away from other efforts. It is important, therefore, to monitor activity and (to paraphrase Kenny Rogers) know when to hold them, and when to fold them.

However, the inherent risk of any commercial activity is fabulous success, and should that happen the institution also needs to be aware of the potential effect a significant sum of unrelated business income might have on its exempt status. Creating systems to monitor and evaluate ongoing efforts at commercial activity is a vital component of any program a profit seeking institution establishes. Regular reports and feedback should be made available to institutional decision makers, and regular meetings with tax advisors should be undertaken to ensure that they do not run afoul of tax law.

WHAT ARE THE IMPLICATIONS FOR HIGHER EDUCATION?

Far from a simple academic exercise, the discussion of UBIT, joint venture

activity, and the creation of for-profit subsidiaries has far-reaching implications for the future of the academic enterprise. Clark Kerr's statement about the soul of the multiversity, true in 1963, was a prescient one when the activity of the past 20 years is considered. What impact does unrelated business activity conducted by tax-exempt academic institutions have on the central mission of the institution?

If the premise that higher education exists to further the aim of creating a better informed and more enlightened society, does allowing higher education institutions to engage in for-profit activity related to the dissemination of knowledge gained through academic research operations fulfill that goal? The basic theory behind classifying education and academic research activity (and the ancillary income that flows from it) as free from taxation, was the promotion of greater research activity. When academe acts to further knowledge for the sake of knowledge, places it in the public domain for all to use and enjoy freely, and reinvests the fruits of that labor in broadening the scope of knowledge generated in the academy all of society is better for it. That is the underlying assumption behind American tax policy in this area. However, when that protection is extended to profit-making ventures not undertaken for the sake of knowledge, but for the sake of maximizing profit, what societal interest is served?

The UBIT statutes go a long way toward leveling the playing field between exempt organizations that engage in businesslike activity and the for-profit corporations with which they compete. But the history of the past 30 years in this area suggests that in many ways placing controls on exempt organizations who engage in for-profit activity is like campaign finance reform—institute a policy and the money will find a way around it. The danger to exempt organizations that enter this arena is that in chasing the promise of substantial income from spin-off activity they run the risk of losing both

their fundamental core principles and, if not structured properly, their exempt status. Institutions that engage in for-profit activity expose themselves to severe tax liability that can potentially have a disastrous effect on their financial resources if they act imprudently, even if they do not lose their exempt status.

This area of practice continues to evolve and is not limited to subsidiary and joint venture activity.⁸⁰ It is somewhat unclear where the future of tax policy will take the academic enterprise. What is clear, however, is that the debate is likely to escalate as to what are appropriate foci for higher education institutions to engage in and to what extent ancillary operations fragment the soul of the institution.

Bok succinctly stated the issue: "flashing yellow lights should appear; however, whenever the institution seeks to make a profit on basic academic functions."⁸¹ In Bok's view, universities that engage in the practice of hotly pursuing ancillary business operations have a problem with their image, as it "subtly changes... universities appear less and less as a charitable institution seeking truth and serving students and more and more as a huge commercial operation that differs from corporations only because there are no shareholders and no dividends."⁸² In the current political climate, that truth should raise red flags for any decision maker concerned with efforts for increased accountability and a hard look at the appropriateness of exempt status many policymakers are now calling for.

While there is a substantial potential gain for an institution which engages in profit making activity, should the subsidy they enjoy in the form of tax protections apply to them when their focus shifts to that area? Does the public benefit from the multiversity engaging in the business arena? This battle to define the soul of the modern university is perhaps what will most shape higher education law and practice in the modern era. ●

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