Nonprofits frequently partner with for-profit companies to support their charitable or educational mission. But these JVs come with great risk and complexity. The risk is that nonprofits lose their tax exempt status because the JV doesn’t closely adhere to the vast regulations governing nonprofits. The complexity involves negotiating and drafting substantial commercial arrangement between entities with differing purposes: What type of property is each entity contributing? What is their allocation of profits/losses and when are cash distributions made? How are governance responsibilities and liability allocated? Who gets what if the JV fails? If not carefully planned and drafted, the JV risks the nonprofit’s exempt status. This program will provide you with a real-world guide to structuring and drafting nonprofit/for-profit JVs, to limit risk for the nonprofit.

- Structuring and drafting non-profit/for-profit and nonprofit/nonprofit joint ventures
- Tradeoffs between entity JVs v. contractual JVs
- Structuring considerations – capitalization, governance, allocations of profits/losses, cash distributions,
- Defining term and termination – and allocation of post-termination ownership rights
- Essential provisions to preserve status of nonprofit and limit risk
- Special issues in JVs between nonprofit organizations
- Administrative and compliance considerations in JVs

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I. TYPES OF JOINT VENTURES

A. What is a Joint Venture

1. The basic idea of a joint venture (hereafter “JV”) is that two (or sometimes more) unrelated parties bring together their resources, expertise, goodwill and/or other assets to pursue a (usually very specific) profit-making opportunity while otherwise remaining independent.

2. Joint ventures are generally either separate legal entities (“Entity JVs”) or contractual arrangements (“Contractual JVs”).

B. Entity JVs

1. As the name suggests, with an Entity JV, a separate legal entity is formed for the conduct of the JV.

2. An Entity JV will almost always be structured as a “pass-through entity” for federal tax purposes so that there are no taxes paid at the entity level. For this reason, corporations are almost never used for joint ventures.

3. The three main pass-through entities are:

   a. General partnership – rarely used any more, as all members of the partnership have unlimited liability for the debts/obligations of the general partnership (a problem sometimes solved by using special purpose entities as the direct general partners; this tends not to be an option where there are tax-exempt participants).

   b. Limited partnership – used these days more often for investments and funds than for joint ventures because (i) it requires at least one partner that has unlimited liability for the debts/obligations of the limited partnership and (ii) there are severe limitations on
participation in management by limited partners (which is typically inconsistent with the needs of the tax-exempt participants).

c. Limited liability company – an entity that combines the advantages of pass-through tax treatment once available only to general and limited partnerships with the limited liability benefits of a corporation. Virtually all entity JVs are now limited liability companies.

C. Contractual JVs

1. As the name suggests, with a Contractual JV, no separate legal entity is created, and all of the parties rights, duties, obligations, and entitlements are specified purely by contract.

2. “Strategic alliances” tend to be structured as Contractual JVs: A typical example is where Party A provides a product or service and Party B provides financing, maintenance or other services related to Party A’s product or service. While this is a mutual undertaking, it is less of a totally shared enterprise.

3. Because Contractual JVs are entirely matters of contract and there is no underlying legal structure for “filling in the blanks” (as there is with partnerships, corporations and limited liability companies), every aspect of the Contractual JV has to be covered by the contract.

D. Entity JVs vs. Contractual JVs

1. There are numerous considerations to the decision of which approach to use, apart from tax: public relations, intellectual property, employment/labor, real property, anti-trust, change-in-control, debtor-creditor – the list is nearly endless.

2. One consideration that tends to dominate the analysis is limited liability protection – where an entity is formed, the participants in the JV can typically obtain limited liability protection through the use of a separate legal entity.

3. Tax considerations tend not to dominate the decision to use an Entity JV or a Contractual JV. Two typical tax considerations are the following:

   a. An entity JV will file federal (and likely state and local) tax returns.

   It should be noted that use of a Contractual JV DOES NOT GUARANTEE that tax returns are not required – a Contractual JV can be deemed to create a taxpayer for tax purposes. This can prove to be a complicated analysis.
b. Where there is a tax-exempt entity participating in the JV, use of an entity JV may provide more certainty as to how to analyze the tax concerns that are typically important to the tax-exempt participant (because IRS guidance has tended to focus more heavily on Entity JVs), such as preservation of 501(c)(3) status and UBIT.

II. STRUCTURING CONSIDERATIONS

A. General Structuring Considerations

Whether or not tax-exempt entities are involved, and whether or not the JV is an Entity JV or a Contractual JV, these are the key terms of a JV (and there will often be many more issues to be addressed):

1. Purpose of the JV
2. Participants
3. Governance and Management
4. Capitalization and financing
5. Sharing of profits and losses
6. Distributions of cash
7. Transfers of interests/admissions of new members
8. Duration and Termination

B. Special Focus Where a Tax-Exempt Entity is a Participant

1. Purpose of the JV – purpose of the JV typically needs to be drafted to specifically reference furthering tax-exempt purposes and other specifics related to tax-exempt nature of the entity.

2. Participants – will the participant be the tax-exempt entity, or a special purpose affiliate of the main tax-exempt entity (whether tax-exempt or for-profit)?

3. Governance and Management – depending on the tax considerations, the tax-exempt participant may seek total governance control, control (direct or by veto rights) over
certain significant elements of the conduct of the JV, or neither. This is often a heavily negotiated matter.

4. Capitalization and financing – In JVs generally, there are virtually no limits to the capitalization and financing arrangements that can be used if the parties agree. However, where there is a tax-exempt participant, considerations of private inurement can significantly affect these decisions. There are also significant issues that will arise if any of the assets to be contributed by the tax-exempt participant have been financed with tax-exempt bonds.

5. Sharing of profits and losses – In JVs generally, there are virtually no limits to the ways that profits and losses can be shared if the parties agree. However, where there is a tax-exempt participant, considerations of private inurement can significantly affect these decisions.

6. Distributions of cash – In JVs generally, there are virtually no limits to the ways that cash can be distributed if the parties agree. However, where there is a tax-exempt participant, considerations of private inurement again can significantly affect these decisions.

7. Transfers of interests/admissions of new members – Because a JV is generally consciously formed by specific participants, transferability of interests and admission of new members is usually severely restricted. Where there is a tax-exempt participant, it will usually seek at a minimum the right to transfer its interest if there are adverse tax implications arising from its participation in the JV.

8. Duration and Termination – JVs typically have unlimited duration except in rare cases, and termination events tend to be narrowly described. Where there is a tax-exempt participant, an additional basis for termination needs to be considered for the situation in which there are adverse tax implications arising from its participation in the JV.

III. FINAL CONSIDERATIONS

There are numerous other matters to consider before entering into a JV, but where tax-exempt participants are involved, two in particular take on heightened concern:

A. Due Diligence

1. The participants may make all required contributions to the JV up-front. Often, however, there are staggered or deferred contributions, or commitments that endure over time (such as guarantees, deficit funding commitments, loan commitments, etc.).
2. Financial due diligence is typical where there are material financial commitments beyond the initial closing, to assess the likelihood that the commitments can be fulfilled. Where there is a tax-exempt participant in the JV, its financial due diligence evaluation of the other JV participants takes on heightened importance for ensuring that the tax-exempt participant is not likely going to be required to subsidize other participants (a private inurement concern).

B. Valuation

1. One or more parties to a JV typically contributes non-cash assets. Often the parties do not appraise or formally value the non-cash assets, but simply mutually agree as to the value to be given to non-cash assets.

2. However, where there is a tax-exempt participant, private agreements as to value may not be a viable approach due to concerns about private inurement.

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