A. UPDATE ON PARTNERSHIPS

by
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1. Introduction

IRM 7664.31(12) currently provides for mandatory referral to the National Office of any application for recognition of exemption filed by an organization participating directly or indirectly in a partnership. IRM 7664.31(12) is being revised to restrict such mandatory referrals to cases involving organizations providing inpatient or outpatient health care. The reasons for the change are explained in this article.

This article also discusses a recent National Office case concerning whether an organization exempt under section 501(d) of the Code is a partnership for federal tax purposes.

2. Background

Prior to 1983, the Service had generally been reluctant to approve the participation of a 501(c)(3) organization in a partnership with nonexempt entities because it was believed that there was an inherent conflict between the exempt organization's obligations to the for-profit partners and its duty to serve a public rather than a private interest.

In Plumstead Theatre Society, Inc. v. Commissioner, 675 F.2d 244 (9th Cir. 1982), the Ninth Circuit Court of Appeals affirmed a decision by the Tax Court holding that a 501(c)(3) arts organization's participation in a partnership with for-profit partners would not disqualify it from tax exemption merely because some investors made a profit from the production of a play. The Court found that participation by the investors was necessary for the organization to achieve its exempt purpose. The Court also found particularly relevant: (1) the investors were not shareholders in or officers or directors of the organization; and (2) the agreement gave full control over the operations to the organization and not to the investors. G.C.M. 39005 (June 28, 1983) provides guidance as to when an organization in the achievement of its exempt purposes may be associated with nonexempt partners and retain its tax exemption.

The G.C.M. notes a two-part test:

(1) Does participation by the exempt organization in the partnership further its exempt purpose?

(2) Does the partnership arrangement permit the exempt organization to act in furtherance of its exempt purposes despite its obligations to the nonexempt partners?

For a more detailed discussion of these issues, see the article in the 1986 Exempt Organizations Continuing Professional Education Technical Instruction Program (1986 CPE text) beginning at page 131.

During the next several years, the Service considered a variety of partnership issues and developed principles in a number of G.C.M.s clarifying the requirements that would be applicable to assure satisfaction of the two-part test in particular circumstances. See the article in the 1987 CPE text beginning at page 219.

In the 1988 CPE text, the Service noted the increasingly complex partnership arrangements being employed by organizations involved in the health care field.

Most recently, the Service published a comprehensive overview of partnerships and joint ventures involving exempt organizations. See the article in the 1993 CPE text beginning at page 44. This article also noted abuses apparent in the sale of a hospital's net revenue stream to private investors.

3. Reasons for Changing Requirements for Referral of Partnership Issues to the National Office

The development of educational materials on partnership issues involving exempt organizations over the past several years has produced a body of knowledge sufficient to enable Key District Offices to deal with most partnership issues. But, the mandatory referral of all partnership issues to the National Office resulted in shifting many cases from the field to the National Office that did not present novel or highly complex issues not clearly covered by precedent. Also, many cases were referred as partnerships or joint ventures that actually involved the sale of goods or services to an exempt organization by an enterprise owned by one of the officers or directors of the organization. Such cases present ordinary private benefit and inurement issues and, as such, are not mandatory referrals to

the National Office.

However, one class of organizations is of continuing concern. Health care provider organizations are experimenting with a variety of arrangements between themselves and private individuals, often physicians or physician groups, as they attempt to improve their financial position in a cost conscious and competitive environment. Many of these cases raise novel issues because they involve new types of organizational structures which have not been in use before. Since we are developing guidance for the treatment of these new organizational structures, applications from health care provider organizations involved in partnerships or joint ventures should continue to be referred to the National Office.

4. Nature of the Change to IRM 7664.31

Subparagraph (12) of IRM 7664.31 is being revised to read as follows:

Applications from the following organizations:

(a) Inpatient or outpatient health care provider organizations that are involved in a partnership either directly as a general or limited partner, or indirectly through a wholly-owned subsidiary organization;

(b) Inpatient or outpatient health care provider organizations that are participants in a joint venture with a for-profit entity; and

(c) Parents of inpatient or outpatient health care provider organizations that are participating in a partnership or joint venture.

5. Cases to be Referred Under the New Standards of IRM 7664.31(12)

The new standards are broad enough to require referral of cases involving not only hospitals, but also faculty practice plans, clinics, outpatient nursing and home medical treatment services, physician-hospital organizations, and integrated delivery systems. This list of organizational types is given for purposes of illustration only and is not intended to limit the types of health care provider organizations required to be referred to the National Office.

6. Section 501(d) Organizations are not Partnerships

In a recently published G.C.M., Chief Counsel considered whether a corporate 501(d) organization should be treated as a partnership so as to allow its members to deduct losses and charitable donations on their individual federal income tax returns.

Section 501(d) of the Code provides exemption from federal income tax for religious or apostolic associations or corporations having a common or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for such year. Any amount so included in the gross income of a member shall be treated as a dividend received.

Under section 1.6033-2(e) of the Income Tax Regulations and the filing instructions for Form 1065, a 501(d) organization is required to file a partnership return on Form 1065. As required by section 501(d), members report their pro rata share of the organization's income as a dividend on their individual tax returns. Based on the fact that a 501(d) organization is required to file a partnership return, members of a 501(d) organization contended that they were entitled to claim their pro rata shares of the organization's losses and charitable contributions on their individual tax returns.

Chief Counsel reviewed the historical reasons for the enactment of section 501(d) and concluded that Congress intended for distributions to members to be treated as a dividend, which meant that corporate items of income and loss remained with the 501(d) rather than being allocated to members as would be the case in a partnership. The fact that, for administrative convenience, the Service had chosen to require the filing of a Form 1065 was not controlling. Therefore, the 501(d) organization and not the individual members was entitled to the benefit of the organization's losses and charitable contributions.

The instructions for Form 1065 have been clarified by adding the following paragraph to the 1994 Form 1065 instructions:

> A religious or apostolic organization exempt from income tax under section 501(d) must file Form 1065 to report its taxable income, which must be allocated to its members as a dividend, whether distributed or not. Such an organization must figure its taxable

income on an attachment to Form 1065 in the same manner as a corporation. Form 1120, U.S. Corporation Income Tax Return, may be used for this purpose. Enter the organization's taxable income, if any, on line 4b of Schedule K and each member's pro rata share on line 4b of Schedule K-1. Net operating losses are not deductible by the members but may be carried back or forward by the organization under the rules of section 172.

7. Summary

Because adequate guidance is available, District Offices will no longer be required to forward all exemption applications involving partnership issues to the National Office.

IRM 7664.31(12) will be amended so that only cases presenting partnership issues involving health care provider organizations will be mandatory referrals to the National Office.

Chief Counsel has determined in a recently published G.C.M. that members of a section 501(d) organization may not be treated as partners for purposes of claiming a pro rata share of the section 501(d) organization's charitable contributions and losses. Instructions to that effect are contained in the 1994 Form 1065 instructions.