N. PARTNERSHIPS

1. Introduction

This article updates previous CPE articles concerning the participation of exempt organizations in partnerships. The purpose of the article is to discuss exempt organization issues involving IRC 501(c)(3) organizations which participate directly, or through subsidiaries, as general partners in limited partnerships with for-profit partners. It also discusses issues raised in this area from a cross-functional viewpoint due to the variety of significant non-EO issues raised by the participation of a charity as sole general partner in a limited partnership.

Partnership arrangements continue to be employed by organizations exempt from federal income tax under IRC 501(c)(3) to share costs and raise capital to finance "big ticket" items. In particular, they are used by hospitals to finance medical office buildings, specialized hospital facilities, and high technology equipment. They are also used to finance the construction of housing projects for low income, elderly, and handicapped persons.

Since publication of the 1986 CPE text, EO tax practitioners have expressed concern with regard to the Service's approach as set forth in private letter rulings (PLRs) and General Counsel Memoranda (G.C.M.s). In addition, the nature and extent of the participation by EOs in partnerships are of current concern to Congress, as indicated by a recent House Ways and Means Committee announcement of proposed review by the Oversight Subcommittee of EO's income-producing activities. There continues to be, however, no published precedent that sets forth the Service's official position.

Our analysis here begins with a summary of several outstanding G.C.M.s directed at the effect of participation in a partnership on exemption under IRC 501(c)(3). The treatment of the exempt organization's receipts from the partnership under IRC 511 through IRC 514 (including fees paid to the EO by the partnership for services and allocations of partnership profits) will be briefly discussed. Certain ancillary, non-EO issues will be described. We will then turn to several fact patterns representative of recently considered ruling and technical advice requests, with the goal of reaching an understanding of the issues involved. Before concluding, we will also look briefly at certain EO "sidelines," representing issues on which we have not previously focused.

2. The Service's Legal Opinions

A. G.C.M. 39005 (June 28, 1983)

An EO serves as one of four general partners in a limited partnership formed to own and operate housing for low-income, handicapped, and elderly residents. The EO's role includes the marketing and rental of the units and operation of social services programs for residents. Profit to investors is restricted under government guidelines. The EO holds a right of first refusal with regard to the property. The for-profit general partners are obligated to cover operating deficits and they were solely obligated to protect the interests of the limited partners. A federally-guaranteed mortgage loan was obtained for construction and the EO had no liability on the nonrecourse mortgage. The G.C.M. notes that in Rev. Rul. 70-585, 1970-2 C.B. 115, an organization aiding low and moderate income families by providing affordable housing qualified for IRC 501(c)(3) exemption by lessening neighborhood tensions, eliminating prejudice and discrimination, and combatting community deterioration.

Chief Counsel concludes that under these facts and circumstances, the EO's activity serves exclusively exempt purposes, and no conflict of interest was demonstrated between its obligations as general partner and its exempt purposes.

Thus, Chief Counsel sets forth a two-part approach that examines all the facts and circumstances. It is necessary to determine whether (1) participation by the EO in the partnership furthers its exempt purposes, and (2) the partnership arrangement permits the EO to act exclusively for exempt purposes despite its obligations, duties, and liabilities as general partner under the particular partnership arrangement negotiated by the parties.

B. G.C.M. 39444 (November 13, 1985)

An EO serves as sole general partner of a limited partnership formed to construct and operate an office building housing the EO general partner and an affiliated organization also exempt under IRC 501(c)(3). The G.C.M. follows the approach suggested by G.C.M. 39005, asking first whether the organization's participation in the partnership serves a charitable purpose. (Although certain statements in G.C.M. 39444 refer to the charitable purpose served by the partnership, it is clear that the intended reference is to the charitable purpose served by the EO as partner.) It then asks whether the particular partnership arrangement permits the EO to act exclusively in furtherance of its exempt purposes.

The primary purpose of the undertaking is to acquire adequate office space at a reasonable cost for the charitable affiliate. Thus, the EO's participation serves a charitable purpose. Close scrutiny of the arrangement showed its fairness and protection for the organization's assets. The limited partners included individuals who were closely associated with the EO partner in their capacity as past and present board members and officers of the EO. Accordingly, additional safeguards were necessary to assure that the EO's participation as general partner did not result in its serving private interests more than incidentally.

Underlying documents including a lease, the partnership agreement, financing instruments, and a prospectus, were examined. They revealed that the lease between the organization and its affiliate was at a fair rental and that the affiliate had assumed responsibility for administrative decisions and operating costs since it occupied the bulk of the property. They also required the limited partners to provide capital contributions for reserves for future renovations, assumption of mortgage liability by the partnership, no disproportionate allocations of profits and losses between partners, and a right of first refusal by the organization to purchase the property at a fair market value. Moreover, since an oversight committee was or will be created to monitor the organization's role in the partnership, the organization was viewed as not serving the private interests of the limited partners who have a strong common interest in the exempt general partner. The benefits to be received by the limited partners are incidental to the public purposes served by the partnership.

The G.C.M. mentions that participation by an exempt organization as a general partner in a limited partnership with for-profit partners was sanctioned in Plumstead Theater Society, Inc. v. Commissioner, 74 T.C. 1324 (1980), aff'd 675 F.2d 244 (9th Cir. 1982). (Plumstead is the sole judicial decision to date involving exemption issues relating to an exempt organization's use of the limited partnership vehicle.) The court found that the partnership arrangement permitted Plumstead, the exempt general partner, to act exclusively in furtherance of its exempt goals and not for private interests other than as incidental to the public purpose served. In this case, Plumstead, seeking recognition under IRC 501(c)(3), intended to co-produce a play by an unknown American playwright with a theater organization recognized as exempt under IRC 501(c)(3). However, the organization ran out of money and sold 63.5 percent of its 50 percent interest in the production for $100,000 to each of three investors through a limited partnership. Plumstead assumed the general partner role. The government's argument that the undertaking constituted a commercial enterprise was dismissed by a finding that the undertaking is an appropriate educational activity under IRC 501(c)(3). Additionally, the partnership arrangement, attacked by the government as not structured to preclude a conflict between Plumstead's fiduciary

obligations to the limited partners and its exempt purposes, was found not to serve impermissible private interests on the facts. The following factors were particularly significant: the parties dealt at arm's length with each other, the sale in the production having been made at a reasonable price; there was no conflict of interest because none of the limited partners was an officer or director of Plumstead; there were no contingent agreements with respect to the limited partners' share of the profits and losses nor was Plumstead required to return the limited partners' capital contributions; the partnership agreement expressly reserved to Plumstead full management and control over its operations; the arrangement, limited to one play, was no greater then Plumstead needed in order to fulfill its public purpose; and Plumstead was not obligated to the limited partners in any way other than to share the stated percentage of profits or losses.

Although Plumstead's partnership arrangement was sanctioned on appeal by the Ninth Circuit Court of Appeals, the government had expressed its concern over the substantial private benefit, absent the structuring of the partnership arrangement to balance Plumstead's duties to the limited partners. In the partnership situation, certain statutory obligations are imposed upon a general partner. The general partner must exercise prudent business judgment and maintain a basic profit orientation in the interest of the limited partners. The organization in Plumstead, under applicable state fiduciary principles governing general partners, was obligated to conduct the venture in a manner reasonably calculated to both benefit the private investors and to maximize their profits. There was no evidence in the record that the organization's obligations were in any way limited or restricted in the agreement or that the limited partners were aware of and accepted such limited participation by the exempt partner. Thus, the partnership agreement was not structured to preclude a conflict of interest between the general partner's legally enforceable fiduciary obligations and its exempt purposes. In effect, the organization in Plumstead subordinated its charitable goals to the profit-seeking orientation of the limited partners. Accordingly, the organization's activities were in furtherance of the substantial nonexempt purpose of serving the private interests of the limited partners and inherently incompatible with status under IRC 501(c)(3).

In Plumstead, where the focus was on the exemption issue, the court did not consider possible partnership rule violations such as disproportionate allocations of losses. See Harry J. Smith, Jr. v. Commissioner, 50 T.C.M. 1444 (1985), discussed below at Part 4 for a situation in which, in contrast, partnership issues were addressed by the court to the exclusion of exempt organizations issues.

C. G.C.M. 39546 (August 15, 1986)

Each case involving an EO as sole general partner in a limited partnership must be carefully scrutinized to determine if there is any conflict between the organization's fulfillment of its fiduciary obligations to the limited partners and its operation exclusively for charitable purposes. The role of the EO may be consistent with exemption. However, it is questionable whether an EO can isolate itself entirely from losses related to the conduct of partnership activity, without jeopardizing the classification of the partnership under section 7701. Although a general partner may provide that any loans will be fully secured, or refuse to obligate itself to make operating loans to the partnership, these provisions may not realistically protect the exempt organization. For example, overruns may require the partnership to obtain additional funds which, if provided in the form of a loan, could raise an issue as to whether it should be considered a capital contribution as set forth in Rev. Rul. 72-135, 1972-1 C.B. 200. Also, a nonrecourse loan to the partnership may not be adequately secured when the occasion for the loan is some form of adverse economic circumstances in the partnership activity.

Chief Counsel notes that Rev. Proc. 72-13, 1972-1 C.B. 735, and Rev. Proc. 74-17, 1974-1 C.B. 438, set forth certain safe harbor guidelines for the classification of an entity as a limited partnership. Discussion and coordination among all Service functions with an interest in the issues raised by the participation of an EO in a partnership is recommended. Ancillary issues include those raised under the tax-exempt leasing provisions.

3. The UBIT Issues

In addition to determining the consistency of partnership arrangements with exemption under IRC 501(c)(3), we also may be asked to determine whether an EO's receipts from partnership activity result in unrelated business taxable income (UBTI) under IRC 512. IRC 512(c) provides that if a trade or business regularly carried on by a partnership, of which an organization is a member, is unrelated trade or business with respect to such organization, the organization in computing its UBTI shall, subject to the limitations of IRC 512(b), include its share, whether or not distributed, of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with the income. In this respect, Rev. Rul. 79-222, 1979-2 C.B. 236 provides that the "look through" rule of IRC 512(c) for determining the taxation of partnership distributions depending on the partnership business applies regardless of whether the interest held by the exempt organization is that of a limited or general partner. The Tax Court agreed, in Service

Bolt and Nut Co. Profit Sharing Trust v. Commissioner, 78 T.C. 812 (1982), aff'd 724 F.2d 519 (6th Cir. 1983).

A partnership may generate two basic categories of potentially taxable income for an EO: fees for services provided to the partnership and allocations of partnership income. By early 1986, some 40 rulings had been released addressing these matters. (See, for example, PLR 8508073 and PLR 8531069.) Arguably, the conclusion that the EO's receipts from both categories will be excludable from UBTI is semi-automatic, once we have determined the consistency of the EO's participation in the partnership with its exempt status. If we have applied the two-pronged approach suggested in G.C.M. 39005, we have already made a determination that the EO's participation serves charitable purposes. (In this respect, the 1984 CPE at page 22 contains a discussion of the use of partnership arrangements by hospitals to finance the construction of medical office buildings.) Is this determination sufficient for a favorable conclusion concerning the UBTI consequences of partnership activity?

Let's turn first to the category of receipts based on services provided by the EO for the partnership (e.g., EO as managing general partner of a housing project or medical office building, EO as provider of administrative services to physician-tenants). Income from such activity may be income from related trade or business, i.e., the EO's activity may be substantially related in a causal fashion to the serving of exempt purposes. However, in this arena it is essential that each of the various sources of income be examined rather than the overall purpose of the partnership and, therefore, sufficient information must be obtained to demonstrate whether there is a substantial causal relationship between the services provided by the EO and its exempt purposes before we reach a conclusion concerning UBTI. See, for example, Rev. Rul. 69-463, 1969-2 C.B. 131, and Rev. Rul. 69-464, 1969-2 C.B. 132, which discuss the UBTI consequences of certain services provided by a hospital to a hospital-based medical group in the absence of a partnership role by the EO.

Similarly, when we turn to the EO's income from the partnership's allocation of income to the partners, we also confront the standard UBTI provisions, although somewhat less directly. Again, it would appear that the determination of the consistency of the organization's role as general partner with its exempt status mandates a favorable ruling regarding the treatment of the EO's share of partnership gross income. However, the UBTI question remains open since here again the sources of the partnership's income must be examined, and not its purposes. For example, although a medical office building adjacent to a hospital could serve exempt purposes and, therefore, debt-financed rental income from physicians will be excluded from UBTI, the treatment of partnership rental income received from a commercial

pharmacy or laboratory tenant in this situation may result in UBTI under IRC 514. Also, partnership income from the partnership's own operation of a pharmacy or laboratory may result in UBTI to the EO general partner, if the pharmacy or laboratory serves individuals other than hospital patients. See Rev. Rul. 85-110, 1985-2 C.B. 166.

4. Ancillary (Non-EO) Issues

Ancillary issues have always been in the background of our rulings concerning EO participation in partnerships. G.C.M. 39546 highlights these issues for the first time as interrelated to our EO issues. Is the arrangement negotiated by the EO with non-exempt entities properly characterized as a partnership for federal tax purposes? What are the proper allocations of items of partnership income, losses and credits? Especially with regard to limited partnerships, a major incentive for the investment of the limited partner frequently will be the anticipated allocation of losses from partnership activities, based in part on depreciation of partnership property. It therefore is crucial to the investor and the EO that the investment is properly characterized as an investment in a partnership. (If the investment vehicle is instead a corporation, of course deductions are not allowed to the investor.) It is also crucial that the Service know the allocations of partnership items, as anticipated by the partners.

What are the operable constraints? IRC 7701(a)(2) defines a partnership as including a syndicate, group, pool, joint venture, or other unincorporated association, through or by means of which any business, financial operation, or venture is carried on, and which is not a trust or estate or corporation. Under Regs. 301.7701-2 and 3 on Procedure and Administration, it is recognized that partnerships and corporations share the common characteristics of associates and an objective to carry on business. Accordingly, it is the remaining four corporate characteristics that are crucial in distinguishing a corporation from a partnership. These are: (1) continuity of life; (2) limited liability; (3) free transferability of interests; and (4) centralization of management. If the organization has three of these four characteristics in addition to the above two common characteristics, it will be classified as a corporation, and not a partnership, for federal tax purposes. Since the limited liability characteristic could be decisive for partnership classification, there is a potential for tension between the EO's role as a general partner with personal liability and its need to protect its assets. This concern is indicated in G.C.M. 39546, discussed at Part 3.

Key to sheltering income through a partnership is a partner's ability to deduct his share of a partnership's tax loss to the extent of the basis of his partnership

interest. As noted by P. Postlewaite and T. Bialosky, Liabilities in the Partnership Context - Policy Concerns and Forthcoming Regulations, 33 UCLA L. Rev. 733, 739 (1986), the use under IRC 752 of liabilities to generate basis is popular because a partner makes only a small initial capital outlay. Concurrently, the partner's basis and therefore the potential for a tax loss deduction increases by his share of the face amount of liability incurred by the partnership. To the extent partners are permitted to share in liabilities, they are permitted to increase the bases of their partnership interests. In situations where an EO is a partner, deductions may be of little value to the exempt partner unless the EO has taxable income from unrelated trade or business. Accordingly, partnership allocations in favor of the taxable partners are of great concern. In addition, the EO may itself be a primary source of financing for the partnership and in this way the limited partners benefit through the increased basis of partnership property derived therefrom.

IRC 704(b) governs the allocation of the partner's distributive items of partnership income, loss, and credits. The partner's share is that specified in the partnership agreement, except where the partnership agreement is silent or the allocation provided under the partnership agreement does not have substantial economic effect. Under those limited circumstances, the partner's share is to be determined in accordance with his interest in the partnership, in turn determined by taking into account all facts and circumstances. Regulations recently issued under section 704(b) (T.D. 8065, 50 FR 53420, December 31, 1985, 1986-1 C.B. 254; and T.D. 8099, 51 FR 32061, September 9, 1986) describe the determination of substantial economic effect, including specific requirements applicable to the allocations of loss and deduction attributable to nonrecourse debt (e.g., mortgage financing). Recourse debt permits the creditor to proceed against the personal assets of the recourse partners, while nonrecourse debt permits the creditor to proceed only against the partnership assets. As stated above, the partner's share of such partnership debts may be reallocated under certain limited circumstances.

In addition, the Tax Reform Act of 1986 (Pub. L. 99-514, Oct. 22, 1986), modified the previous tax shelter provisions and added new IRC 469, so that losses and credits from passive activity, including any interest in a limited partnership, are limited based on the investor's amount at risk. Also, restrictions imposed on the treatment of nonrecourse financing as an amount at risk were further clarified.

In Rev. Proc. 86-12, 1986-1 C.B. 534, the Service modified its previous no-ruling position with regard to certain partnership issues. The Service announced that it would issue rulings concerning the classification of an existing organization as a partnership and, further that it would issue subchapter K rulings based on a newly

formed organization's declaration that it is properly classified as a partnership. Accordingly, partnerships in which EOs participate may receive guidance from the Individual Income Tax Division (CC:IND) as to their proper classification and as to the availability of deductions or other allocations.

In any event, our EO rulings may not be read as providing reliance for partnership issues including classification that are not specifically addressed in the rulings. In order to prevent reliance on EO rulings in these matters, EO rulings now contain the following caveat:

> This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than the sections described above.

As noted in G.C.M. 39546, the tax exempt leasing provisions are of concern. The purpose of the tax exempt leasing provisions is to eliminate large deductions and credits where no taxable income exists. The provisions were originally designed to prevent sale/leaseback transactions between EOs and taxable entities intended to generate deductions and credits for the taxable buyer. Such deductions would otherwise be lost to the EO since its income from the property would generally constitute related receipts not subject to tax under the UBTI provisions. A relatively readable description of the provisions, prior to their amendment by the 1986 tax legislation, is set forth in C. B. Edgar's article in Taxes, Vol. 64 No. 2, (February 1986), pp. 81-98. Basically, under IRC 168(j) (now section 168(h) as amended by the 1986 Tax Reform Act), the benefit of deductions under the accelerated cost recovery system (ACRS) is not available with regard to "tax-exempt use property." Such property includes property leased to an EO that is not used predominantly in unrelated trade or business, and then only under certain limited circumstances. For example, a hospital, exempt under IRC 501(c)(3), leases 50 percent of the space in a building from a partnership for a five-year term. In this circumstance, 50 percent of the property is tax-exempt use property subject to the depreciation and investment tax credit limitations of IRC 168(h). A special exclusion is provided for high technology equipment.

Tax-exempt use property also includes the tax-exempt entity's proportionate share of property owned by a partnership that includes the EO and taxable entities as partners, but only if any allocation to the tax-exempt entity of partnership items is not a "qualified allocation." A qualified allocation is one that is consistent with the entity's allocation of the same distributive share item of income, gain, etc., that remains the same during the entire period the entity is a partner and, further, that has

substantial economic effect. Property leased by a partnership which includes an EO and non-exempt entities may also be subject to the tax-exempt use rules. For example, a school exempt under IRC 501(c)(3) and a taxable entity form a partnership to develop a building. The school is allocated one percent of all partnership items and 99 percent is allocated to the taxable entity. However, upon the sale of the building, the school is allocated a 70 percent share of the gain and the taxable entity is allocated the remaining 30 percent share of the gain. In this circumstance, there is not a qualified allocation and the property is tax-exempt use property subject to the depreciation limitations of IRC 168(h).

Further, under IRC 48(a)(4), the investment tax credit (ITC) provisions are affected by the determination that property is tax-exempt use property. Similar principles are applicable with regard to the determination of a partner's share of ITC to those applied with regard to ACRS deductions.

The 1986 Tax Reform Act repealed the ITC. In addition, amendments were made to the ACRS provisions, modifying the accelerated deductions available and the deductions allowed under the "alternative depreciation system" for tax-exempt use property. In addition, a special provision was enacted with regard to the participation of for-profit subsidiaries of EOs in partnerships. For purposes of the IRC 168 provisions regarding partnerships, any entity controlled by an EO is treated as a tax-exempt entity unless the election described below is made. That is, we may see tax-exempt use property even though an EO uses a for-profit subsidiary to participate in a partnership as general partner. Under new IRC 168(h)(6)(F), an election is made available to have any gain from the partnership recognized by the exempt parent and any dividends or interest accrued from the taxable corporation treated as UBTI.

There are also classification issues with regard to the proper treatment of an arrangement as a lease for purposes of IRC 168. Under IRC 168, a lease is defined as any grant of a right to use property. IRC 7701(e)(1) provides rules for treating a contract which purports to be a service contract as a lease. All relevant facts and circumstances are to be considered. Further, under IRC 7701(e)(2), a "partnership" may be recharacterized as a lease.

The Code provisions briefly noted above indicate the complexity of the considerations that arise when an EO participates in a partnership with non-exempt partners and the various ways in which Congress has limited the deductions allocable to the non-exempt partners. A somewhat different approach from the one taken in Plumstead, discussed above at Part 2, was adopted to remedy an abuse-type situation in a recent Tax Court Memorandum decision, Harry J. Smith, Jr. v. Commissioner, 50

T.C.M. 1444 (1985). The court disallowed entirely all deductions claimed by the taxable partners on the rationale that there had been no transfer of ownership of property to the partnership. The facts were as follows: Georgetown University had purchased a dormitory for approximately $6 million. A limited partnership was formed, with Georgetown as sole general partner. Several individual investors were to contribute a total of $300,000 over a five-year period in return for an 80 percent interest as limited partners. The university transferred the dormitory, mortgaged for $4 million, to the partnership in exchange for a 20 percent interest as general partner, a note for approximately $3 million, and a credit to Georgetown's capital account. In obtaining mortgage financing, Georgetown agreed to guarantee that it would fund all operating deficits of the property. In the event of the decision to redevelop the property, the limited partners could be called on for additional capital contributions. In the years in question, the dormitory continued to operate at a loss. Based on the partnership agreement, accordingly, no interest was paid to Georgetown on the note. Instead, Georgetown's capital account was credited with the interest. Georgetown continued to manage and make all decisions with respect to the property. Operating expenses were paid with the university's checks, with the exception of the mortgage interest expense which was paid with amounts transferred by the university to the partnership's checking account. With the exception of the $300,000 equity contribution by the limited partners, Georgetown funded all operating deficits of the dormitory.

The court agreed with the Service that under these circumstances, despite the formation of the partnership, Georgetown had maintained the benefits and burdens of ownership of the property. For federal tax purposes, the mere form of the transaction was not controlling. Accordingly, the losses claimed by the limited partners were disallowed.

The court did not have the issue before it of the effect of the transaction on the university's exempt status. Questions as to whether the university served the private interests of the limited partners, despite the lack of success of the limited partners in obtaining anticipated tax benefits, could also have been raised.

5. The EO as General Partner - Representative Fact Patterns

The following material presented in Parts 5 and 6 of this article is in part based on PLRs recently issued by the Exempt Organization Rulings Branch. The PLRs and the hypotheticals are not presented as precedent or as statements of the Service's position, but instead to demonstrate the variety of fact patterns we have seen in recent

years and to serve as a context for the application of the EO and ancillary issues briefly presented above.

A. Consider the following. A, an EO and the sole member of hospital B, will serve as sole general partner of a limited partnership that will own and operate an ambulatory surgery center adjacent to B for the convenience and benefit of B's patients. The partnership will lease space from A. The partnership will retain A to provide certain management services. Although an affiliate of A will initially serve as the limited partner, limited partnership units will later be sold to staff physicians of B. Following the completion of the offering, A will hold a 50 percent interest in the partnership, and the limited partners will hold an equal interest, based on their equal equity contributions. Profits and losses will be allocated directly in proportion to capital contributions. There will be no special allocations of partnership items of income, gain, deduction, or credits to any partners. If the partnership requires additional financing for its operations, it will turn to commercial sources. In PLR 8531069, it was concluded that under these circumstances, A's activity will not jeopardize A's exempt status under IRC 501(c)(3) and will constitute the conduct of related trade or business under IRC 511 through IRC 513, since participation in the partnership will enable A to provide better medical facilities to the community. Also, while A has accepted the risks and obligations attendant upon its role as sole general partner, conflict between A's role as partner and its exempt purpose of promoting health is minimized because A has management control, rent is fixed at fair market value, and there will be straight allocations of profits and losses based on capital contributions. Although A has attracted capital through the partnership vehicle which will be used to establish an ambulatory surgery center, these facts appear to raise no need for special consideration with regard to ancillary issues of partnership classification and partnership allocations.

B. What next? Consider the following variation on the above. A hospital will own a 50 percent interest in a limited partnership, 10 percent as general partner and 40 percent as limited partner (with its limited partnership interest subject to sale to staff physicians). Staff physicians own the balance of the partnership interests as limited partners. The partnership will pay a fixed price to an exempt affiliate of the hospital for "the net revenue stream" from the affiliate's operation of an ambulatory surgery center over a five-year period. Thus, the limited partner staff physicians (and the hospital) will gain an interest in the profitable operation of the ambulatory surgery center and thereby an incentive to increase partnership use of the facility.

Here, we have moved from partnership ownership of property and operation of an activity, e.g., ownership and operation of a medical office building, a magnetic

resonance imaging facility, low-income housing, or an ambulatory surgery facility, to a "purer" state of affairs. The partnership's only function is to own the net revenue stream from an activity. Although limited partners would not have a role in the management or conduct of partnership activity, here the partnership itself has become a very passive entity, with a role limited to providing some funds for use by an EO. An EO and not the partnership will continue to own and operate the facility in question. The hospital's role as general partner in this partnership does not clearly serve exempt purposes. There is a distinction between this partnership and a partnership which itself operates a facility. This particular arrangement, despite the partnership packaging, may merely be an arrangement between an EO and its staff physicians for the sharing of net profits from hospital activity. Accordingly, the EO's partnership activity could be found to further private interests, thereby endangering exemption.

C. Another interesting hypothetical is as follows. A hospital will serve as sole general partner of two partnerships, Property Partnership and Operating Partnership. Staff physicians will be limited partners. The hospital general partner will hold a one percent partnership interest in Property Partnership, with limited partners holding the balance of the partnership units. The capital contributions of the partners are proportionate to their partnership interests. Property Partnership will lease land from the hospital for a 50-year term at fair market rates. Property Partnership will borrow funds from the hospital for the construction of a building to serve as a magnetic resonance imaging (MRI) facility and to purchase MRI equipment. The total borrowed from the hospital will be approximately seven times the capital contributions of the partners. Property Partnership will then lease the building and equipment to Operating Partnership at fair market rates. The hospital will hold an 80 percent interest in Operating Partnership, with the limited partners holding the balance. Capital contributions of the partners are proportionate to their partnership interests. Operating Partnership will bill the hospital for services for each individual seen at the MRI facility. The hospital in turn will bill third party payors. Physicians will separately bill patients for their professional fees. It is represented that all those seen at the facility are hospital patients. The hospital will provide Operating Partnership certain services, including administrative and laundry services, at cost. At the end of the partnership term, the hospital will be required to purchase the Property Partnership's real property at fair market value.

Here, through the partnership structure, an attempt was made to filter tax benefit losses generated by Property Partnership to limited partner staff physicians, while the EO retains a sizable share of operating income from the activity proposed. Does this work?

The hospital's role in both partnerships appears related to its exempt purposes. Further, even the hospital's provision of financing for Property Partnership may not place the hospital in a position of excessive risk. Assuming a market rate of return on the loans and sufficient security, it would appear that the hospital has sufficiently protected its assets. However, this fact pattern would appear to raise significant issues. The financing provided by the hospital may result in a redetermination of the hospital's interest in Property Partnership pursuant to Rev. Rul. 72-135, supra (see G.C.M. 39546). That is, if the hospital has made an additional equity contribution disguised as a loan to the partnership, there would be a reallocation of partnership interests. Further, the reallocation could result in an assertion of private benefit based on a disproportionate allocation of partnership interests and the use of hospital loans to generate tax benefits for the limited partners. In this regard, Rev. Rul. 62-333, 1962-2 C.B. 121, 122, Question 3, described a situation in which a contribution by an exempt hospital, in excess of its proportionate share based on benefits derived, to a cooperative laundry service organization with nonexempt members might result in inurement to the benefit of the proprietary hospital and, therefore, would not be an expenditure in furtherance of exempt purposes.

6. From the Sidelines

The above discussions have highlighted certain considerations applied when an organization exempt under IRC 501(c)(3) participates as a general partner in a partnership in which it may be demonstrated that the exempt organization's role is related to exempt purposes, although non-exempt partners gain certain benefits from partnership activity. However, EO partnership activity is not limited to this situation. Consider the following.

A. The executor of an estate negotiates the formation of a limited partnership to replace a general partnership as owner of certain mineral interests. The new limited partnership is structured to reflect the profits interests formerly held by the partners in the general partnership. A charitable testamentary trust is to hold an interest in the partnership as limited partner, and an exempt corporation formed by the trust is to hold an interest as general partner. The remaining limited and general partners are taxable. The total profits interests of the general partners is 0.1 percent, while the limited partners hold the balance of 99.9 percent. The charitable trust has other significant assets, and it is anticipated that the limited partnership interest will provide less than 1 percent of the total annual income of the trust.

Is the trust's participation in the partnership as limited partner consistent with exemption under IRC 501(c)(3), and is the corporation's participation as general partner consistent with its exemption, also under IRC 501(c)(3)? The first question can be readily answered. There appear to be no inconsistencies between an investment as a limited partner and the trust's exempt purposes, as a limited partner's role is limited to collecting income from its investment. The treatment of such income would be governed by IRC 512(c) and the principles set forth in Rev. Rul. 79-222, 1979-2 C.B. 236. That is, so long as partnership income would be excluded from UBTI under the provisions of IRC 512(b), including the exclusions applicable to interest, rents, and royalties, allocations of partnership income to the exempt partners would be excluded.

Turning to the corporation as a general partner, it shares a management role with fellow general partners, and it shares the obligation to protect the interests of the limited partners. Commentators have suggested that the approach applied in the line of G.C.M.s described above precludes a favorable ruling with regard to the consistency of participation of an organization exempt under IRC 501(c)(3) as a general partner in a partnership with solely investment objectives. For example, see Whitebread, Tax Management, Vol. 11, No. 5, (September 11, 1986), pp. 141-148. That is, the first step of the two-pronged analysis asks whether the EO's role serves exempt purposes. In the investment-type partnership, it does not (apart from producing income for use for exempt purposes). However, in PLR 8638140, describing such an investment partnership, the corporation's exempt status under IRC 501(c)(3) was not considered inconsistent with its role as general partner. Does this conflict with the two-pronged analysis that has been applied to partnerships? Certainly, the PLR describes a rather restrictive set of facts, including the acquisition of the partnership interests by bequest rather than by purchase. At this time, however, there is no official Service position on this issue.

B. Another representative hypothetical is as follows. An exempt hospital forms a wholly-owned, for-profit subsidiary to serve as sole general partner of a limited partnership which will own and operate a medical office building (MOB) adjacent to the hospital. The general partner will receive a one percent partnership interest in exchange for the contribution of certain easements. Limited partners (hospital staff members, including MOB tenants) will hold the balance of 99 percent, in exchange for their equity contributions. On sale of the partnership property, the general partner will receive a 20 percent share of net profits. The hospital will construct the MOB. The partnership will then execute a ground lease and purchase the MOB from the hospital at fair market value.

Here, a controlled, taxable subsidiary has been substituted for an EO as sole general partner. What effect should this have on our considerations of the partnership transactions and their effect on the continued exempt status of the EOs involved? In PLR 8632055, the basis for this hypothetical, the Service ruled that a hospital's construction of the MOB and sale to the limited partnership of condominium units representing several floors of the MOB would not jeopardize the exemption of the hospital and its parent. No particular statement was made with regard to the formation of a separate, taxable entity to serve as general partner. It was concluded that the allocation of profits and losses between limited partners and the general partner reflects economic reality, and the tax-exempt entities were adequately protected through arm's length transactions.

The financing of the partnership purchase described in the PLR was complex. It included the use of tax-exempt revenue bonds issued by the partnership. In addition, the partnership was to issue certain other bonds secured by a second mortgage on partnership property, and the hospital proposed to buy at least some of these bonds. That is, despite the absence of a direct role of the hospital or its parent in assisting the limited partners in financing their purchase of partnership units, an EO would have a significant role in the financing of the partnership's acquisition of the property. Under these circumstances, what is the impact of the use of a taxable subsidiary as the general partner in the partnership?

If we turn to the treatment of the non-EO issues that are raised in partnership cases for potential guidance in handling the EO issues, we note that Congress recently decided to provide identical treatment under IRC 168 for a partnership that includes a taxable subsidiary of an exempt organization and a partnership with the EO itself as member. Accordingly, the MOB could be tax-exempt use property subject to IRC 168(h) since the partnership allocations are not qualified allocations in that they vary during the term of the partnership and the partnership may be recharacterized as a lease. (See Part 4.) It would appear, however, that in our consideration of the EO issues raised by partnership transactions, we may not be able to treat the two situations identically, so long as a separate corporate identity is maintained for the general partner and its exempt parent. After all, it is the taxable general partner and not an EO that has accepted a fiduciary obligation to serve the profit motives of the limited partners. However, we still have to look carefully at the role played by the exempt entities involved in partnership formation and activity. Certainly, it is an exempt entity that provided the funds necessary for the capitalization of the general partner. What standards are applicable with regard to determining the consistency of such funding with continued exempt status? This issue is unresolved.

C. Another hypothetical of interest arose outside of the IRC 501(c)(3) area. What are the restrictions governing participation in partnerships by a IRC 501(c)(2) organization? Just as a IRC 501(c)(3) organization must be organized and operated exclusively for its exempt purposes, a IRC 501(c)(2) corporation must also meet a strict organizational and operational test. It must be organized and operated exclusively to hold title to property, collect the income therefrom, and turn over net income to its parent, an organization exempt under IRC 501(a). The receipt of UBTI, other than UBTI resulting from the application of certain specified Code provisions, is precluded. Consider the following.

A corporation organized exclusively for exempt purposes under IRC 501(c)(2) proposes to invest as limited partner in a limited partnership formed to engage in the securities business. The partnership derives income solely from dividends, interest, and the sale of securities. Are the allocations of partnership income to the title holding corporation inconsistent with its exempt status under IRC 501(c)(2)? It would appear that so long as the allocated income is excludable under IRC 512(b) and therefore does not result in UBTI under IRC 512(c), the limited partner's role is not inconsistent with IRC 501(c)(2) exemption. As limited partner, the corporation is not engaging in activity other than holding title to property, collecting resulting income and turning it over to its parent. However, what would be the result if the title holding corporation were instead a general partner? Again, there is no precedent in this area. If the business activity of the partnership is attributed to each general partner, then so long as partnership activity is limited to activity which the title holding corporation itself could directly conduct (e.g., own and operate an office building), the general partner's role would appear consistent with IRC 501(c)(2) exemption.

7. What Next?

No neat set of conclusions regarding the participation of an IRC 501(c)(3) organization or other exempt organization in a partnership with non-exempt partners can be reached. After determining that an EO's participation in a partnership with for-profit interests furthers charitable purposes, all the facts and circumstances must be scrutinized to ensure that the participating EO is not overly benefiting the for-profit partners. Although rulings have been issued relying in part on the causal relationship between an EO's role as general partner and its exempt purposes, it is unclear whether an EO may participate in a partnership absent such a relationship.

Full development of all ruling and technical advice requests involving partnerships is necessary. The partnership agreement, leases, and all other relevant documents should be obtained. The file should include complete information

concerning allocations of partnership items and financial projections. The financing of partnership activity should be described in detail. The role of the exempt partner, including its continued control or use of partnership property, its provision of services to the partnership, its role with regard to financing of partnership activity, and the funding of operating deficits, its relationship to limited partners, and any reversion of partnership property or purchase options it holds, should be fully explored.

An issue may then arise with regard to the relationship between the non-EO issues (e.g., partnership allocations) and EO issues (e.g., private benefit or inurement). What is the effect of an adjustment to an allocation of a partnership item on rulings requested regarding exempt status? This question has not been resolved.

Partnership cases involving EOs represent a complicated area in which no one Service function may be able to separately resolve a particular case. Therefore, within the key districts, consideration should be given by the EO Examination function to referrals to Examination. Within the National Office, referral to appropriate Service functions to resolve issues of partnership classification and allocations should also be considered. In addition, as provided in IRM 7664.31(15), referral from District Determination Groups to the National Office is mandatory with regard to any application for recognition of exemption filed by an organization participating directly or indirectly in a partnership.