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The Participation of Charities in Limited Partnerships

In recent years, the activities of tax-exempt charities have increased both in number and in complexity.¹ To finance this upsurge in activity, charities have had to seek out new sources of revenue. Some have raised capital by joining with profit-motivated investors in limited partnerships.² In its capacity as the general partner, a charity can ensure that the funds and services it contributes are properly used to accomplish charitable objectives.

The Internal Revenue Service (IRS) has reacted inconsistently to the participation of charities in limited partnerships, allowing such arrangements in some instances, while disapproving them in others. The IRS opposes the participation of charities in limited partnerships on the ground that the charity will further the private interests of profit-motivated limited partners in violation of the Internal Revenue Code's requirement that tax-exempt charities be operated exclusively for public purposes. The IRS further argues that the fiduciary duty that a charity owes to its limited partners will make it vulnerable to a conflict of interest between maximizing profits and achieving its charitable goals. Finally, distributions to limited partners might constitute a diversion of the charity's resources to the private persons who control its operations; charities might unfairly compete with noncharitable organizations for capital; and transferring tax benefits from tax-exempt to taxable entities through a limited partnership is contrary to public policy.

Although this Note takes no position on whether charities should be encouraged to form limited partnerships to raise capital,³ it does argue that such arrangements are often consistent with the principles underlying

1. Between 1968 and 1979, the total number of tax-exempt charities increased from 137,500 to 293,900. See Weisbrod, *Assets and Employment in the Nonprofit Sector*, 10 PUB. FIN. Q. 403, 412-13 (1982); see also Hansmann, *The Rationale For Exempting Nonprofit Organizations From Corporate Income Taxation*, 91 YALE L.J. 54 (1981) (noting growth in scope of nonprofit activities).

2. A limited partnership is a type of partnership comprised of one or more general partners who manage the business and who are personally liable for partnership debts, and one or more limited partners, who contribute capital and share in profits but who take no part in running the business and incur no liability with respect to partnership obligations beyond contribution. See *Evans v. Galardi*, 16 Cal. 3d 300, 305, 546 P.2d 313, 317, 128 Cal. Rptr. 25, 29 (1976); UNIF. LIMITED PARTNERSHIP ACT §§ 1-10, 6 U.L.A. 561, 562-90 (1969).

3. A discussion of the desirability of the current federal tax policy encouraging the provision of public goods and services by the charitable private sector through tax incentives is also beyond the scope of this Note. For a general discussion of this issue, see S. SURREY, *PATHWAYS TO TAX REFORM* 223-32 (1973) (criticizing charitable gift deduction); Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?*, 28 TAX L. REV. 37, 56-62 (1972) (asserting that charitable gift deduction is desirable).

the federal policy of exempting such organizations from taxation⁴ and permitting them to receive tax deductible donations from private individuals.⁵ Partnership distributions do not necessarily reflect a purpose to benefit private individuals; a carefully drafted partnership agreement can help to prevent conflicts of interest; there is no evidence that charities unfairly compete with private enterprises for capital; finally, although the limited partnership vehicle may enable charities to transfer tax benefits to taxable entities, current tax policy permits such transfers as long as they have economic substance.

I. CHARITIES AND THE FEDERAL INCOME TAX

Section 501 of the Internal Revenue Code exempts certain nonprofit organizations,⁶ ranging from colleges and hospitals to social clubs and credit unions, from paying federal income taxes. Section 501(c)(3) describes those entities "organized and operated exclusively for religious, charitable, scientific . . . or educational purposes"⁷ Organizations that fall within Section 501(c)(3) are frequently termed charities.⁸ In addition to their exemption from federal income taxation and their ability to receive tax-deductible donations,⁹ charities also receive favorable treatment in many other areas of the law: They are not required to pay federal

4. I.R.C. § 501(c)(3) (1982).

5. *Id.* § 170.

6. Hansmann defines a nonprofit organization as "an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees." Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

7. I.R.C. § 501(c)(3) (1982) refers to:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

Among the numerous tax-exempt organizations excluded from § 501(c)(3) are labor organizations, business leagues, social clubs, fraternal societies, life insurance companies, and credit unions. I.R.C. § 501(c) (1982).

8. The term "charities" encompasses both private foundations and publicly supported charities. The Code classifies all § 501(c)(3) organizations except those with broad public support or those that function in a supporting role to publicly supported charities as private foundations. I.R.C. § 509(a) (1982). Private foundations are subject to extensive regulation by the federal government regarding their investments and distributions. *See id.* §§ 4941-4945. Private foundations must also pay an annual tax on net investment income. *See id.* § 4940. *See generally* B. HOPKINS, *THE LAW OF TAX EXEMPT ORGANIZATIONS* 375-540 (4th ed. 1983) (summarizing federal tax treatment of private foundations).

9. I.R.C. § 170 (1982).

unemployment taxes;¹⁰ they pay preferential mailing rates;¹¹ and they are not subject to involuntary bankruptcy proceedings.¹²

To qualify as a charity under Section 501(c)(3), an organization must fulfill several requirements. First, the applicant must satisfy the "organizational test" by limiting its purposes, in its charter, to one or more exempt objectives. The organization must not expressly empower itself to engage in more than an "insubstantial" number of activities that would not further these exempt purposes.¹³ Second, the organization must satisfy the "operational test," which requires it to engage primarily in activities that accomplish one or more exempt purposes. If more than an "insubstantial part" of its activities further a non-exempt purpose, then the organization fails the operational test.¹⁴ The organization must also ensure that none of its net earnings inure to the benefit of any private shareholder or individual.¹⁵

One of the principal rationales behind the favorable tax treatment accorded charities is the belief that, by providing public goods and services through the private sector, charitable organizations lessen the burdens of

10. *Id.* § 3306(c)(8).

11. 39 U.S.C. § 3626 (1976 & Supp. V 1981).

12. 11 U.S.C. § 303(a) (1982).

13. Treas. Reg. § 1.501(c)(3)-1(b) (1960).

14. Treas. Reg. § 1.501(c)(3)-1(c)(1) (1960) states:

An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

15. In addition to the explicit statement in the text of § 501(c)(3), the prohibition on inurement of net earnings appears twice in the Treasury Regulations accompanying the statute. Treas. Reg. § 1.501(c)(3)-1(c)(2) (1960) provides: "An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals."

Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1960) provides:

An organization is not organized or operated exclusively for one or more of the purposes . . . unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

The inurement clause prohibits "private shareholders or individuals" from receiving both monetary and non-monetary benefits from the charity. For a description of various types of inurement, see B. HOPKINS, *supra* note 8, at 217-28. Most commentators and courts apply the inurement prohibition only to those individuals who are insiders of the charity or to those who otherwise maintain some direct control over its operations. See *infra* p. 1369.

The organization must also ensure that only an insubstantial part of its activities goes towards legislative lobbying. Treas. Reg. § 1.501(c)(3)-1(b)(3)(i) (1960). Many organizations exempt from taxation under I.R.C. § 501(c)(3), however, may participate in efforts to influence legislation regardless of whether such activities constitute a substantial part of their total activities. The Code permits such organizations to engage in lobbying and grassroots activities as long as the amount of funds devoted to such endeavors falls below specified ceilings. See I.R.C. § 501(h)(1) (1982). Charities that desire to be judged under this standard rather than the substantiality test must elect such treatment. See *id.* § 501(h)(3).

government and thus ultimately save it money.¹⁶ In addition, some believe that providing public goods and services through the private, rather than public, sector is inherently desirable in a pluralistic society.¹⁷ Finally, some analysts argue that as a matter of tax theory charities cannot be taxed and donations should be deductible.¹⁸

II. THE USE OF LIMITED PARTNERSHIPS BY CHARITIES

A. *Raising Capital Through Limited Partnerships*

In recent years, the nonprofit sector has grown dramatically in both size and scope.¹⁹ Especially in light of current cutbacks in both federal funding and federal provision of social services,²⁰ charities require larger amounts of capital to support their growing list of activities,²¹ the most capital intensive of which include the production of theatrical and artistic events, the purchase of scientific and medical equipment, and the construction of low-and moderate-income housing. To raise money for these activities,

16. According to the House report accompanying the Revenue Act of 1938:

The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.

H.R. REP. NO. 1860, 75th Cong., 3d Sess. 19 (1938), reprinted in 1939-1 (Part II) C.B. 728, 742; see R. DESIDERIO & S. TAYLOR, PLANNING TAX EXEMPT ORGANIZATIONS § 4.03, at 4-15 (1983).

17. See, e.g., *Green v. Connally*, 330 F. Supp. 1150, 1162 (D.D.C. 1971) ("[S]ociety can be seen as benefiting not only from the application of private wealth to specific purposes in the public interest but also from the variety of choices made by individual philanthropists as to which activities to subsidize."), *aff'd sub nom. Coit v. Green*, 404 U.S. 997 (1971); Broughton, *The Economic Function of Foundations*, FOUND. NEWS, Sept. 1964, at 1, 2-4 (free enterprise in philanthropy leads to creative innovation).

18. See Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 347-75 (1972) (charitable gifts should not be included in taxable income of donor); Bittker & Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 307-16 (1976) (nonprofit organizations are not suitable targets for an income tax).

19. See Sumariwalla, *Preliminary Observations on Scope, Size and Classification of the Sector*, in INDEPENDENT SECTOR, WORKING PAPERS FOR SPRING RESEARCH FORUM: SINCE THE FILER COMMISSION 181, 197-200 (1983). From 1960 to 1975, the share of the gross national product originating in the nonprofit sector (in current dollars) increased by more than 52%. *Id.* at 197. From 1975 to 1980, revenues received by nonprofit organizations approximately doubled, reaching \$180 billion in 1980. *Id.* at 199. An estimated 5.6 million persons were employed by philanthropic organizations in 1980. *Id.* at 198; see also Oleck, *Nature of Nonprofit Organizations in 1979*, 10 TOLEDO L. REV. 962, 965-68 (1979) (related statistics on growth of philanthropic sector).

20. A recent study estimates that current budget proposals would cut federal aid to nonprofit organizations by \$33 billion over 1982-1985. See L. SALAMON & A. ABRAMSON, THE FEDERAL BUDGET AND THE NONPROFIT SECTOR 46 (1982). Demand for nonprofit services would greatly increase over this time period due to federal social service cutbacks. See *id.* at 1-2; see also Coyle, *Reagan Budget Cuts Leave Non-Profits Slashing Staff, Scrambling For Help*, 15 NAT'L J. 1630 (1983) (describing how nonprofit organizations are adapting to budget cuts).

21. See J. CRIMMINS & M. KEIL, ENTERPRISE IN THE NONPROFIT SECTOR 22-23 (1983); Skloot, *Should Not-For-Profits Go Into Business?*, 61 HARV. BUS. REV. 20 (1983).

several charities have participated as general partners in limited partnerships with profit-motivated investors.²²

Certain factors make the limited partnership an important and attractive vehicle for charities or other nonprofit organizations seeking additional funds. First, many conventional sources of capital are closed to nonprofit organizations either because of prohibitions within state law²³ or because of the reluctance of commercial firms to lend to charities.²⁴ The limited partnership gives the nonprofit organization access to funds from people who are willing to invest in activities that have some chance of generating a return on invested capital and, at the very least, promise attractive tax benefits.²⁵ The limited liability of such a partnership may

22. See *infra* p. 1361.

23. State law prevents charities from issuing equity stock, thereby foreclosing one method of acquiring capital. The *Model Non-Profit Act* states:

A corporation shall not have or issue shares of stock. No dividend shall be paid and no part of the income or profit of a corporation shall be distributed to its members, directors or officers.

MODEL NON-PROFIT ACT § 26 (1964). The Model Act has been adopted in whole or in part in a substantial number of states. See Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 528 (1981).

24. Commercial lending institutions are frequently reluctant to lend to nonprofit organizations on terms comparable to business firms because of the risk they perceive in making loans to organizations that are not profit-motivated, generally have small net worths, and frequently have no track record of successful projects. Interview with Clark Maylone, Exec. Dir., Nonprofit Management Assoc., Washington, D.C. (Aug. 3, 1983). Cf. Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017, 1029 & n.36 (1982) (lenders may charge nonprofit organizations interest rates that exceed competitive returns due to a belief that such borrowers may be "untrustworthy users of investment funds").

In addition, firms may avoid lending to nonprofit organizations due to the risk inherent in many of these organizations' activities. Frequently, nonprofit organizations will become involved in projects that the profit-motivated sector has rejected because the risk of the projects is not justified by their profitability. For example, many nonprofit organizations have sponsored housing for low- and moderate-income households in neighborhoods of extreme poverty. Profit-motivated developers will often bypass such projects because of perceived risks such as further neighborhood deterioration, arson, and community opposition. See M. Schill, *Nonprofit Housing For Low and Moderate Income Households* 15 & n.34 (unpublished paper on file with *Yale Law Journal*).

Finally, creditors may avoid making loans to nonprofit organizations since many of these organizations are immune to actions for involuntary reorganization under the bankruptcy law. Under 11 U.S.C. § 303(a) (1982), an entity that is "not a moneyed, business, or commercial corporation" is not subject to an action for involuntary reorganization. Charitable organizations are considered to fall within this exception. See *In re Allen Univ.*, 497 F.2d 346, 348 (4th Cir. 1974) (university not subject to action for involuntary reorganization under § 22 of the former Bankruptcy Act); S. REP. NO. 989, 95th Cong., 2d Sess. 32, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787, 5818 (eleemosynary institutions such as churches, schools, and charitable organizations and foundations exempt from involuntary bankruptcy).

25. The Internal Revenue Code accords limited partnerships the same tax treatment as other types of partnerships. It provides that: "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." I.R.C. § 701 (1982). Each partner is required individually to take into account his or her appropriate distributive share of the specified classes of partnership income, gain, loss, deduction, or credit. See *id.* § 702(a).

In many instances, the income from a partnership's activities alone will be too small to justify investment by limited partners. The "flow through" nature of items of partnership income, gain, and loss for tax purposes will often increase the return considerably. Since most partnership activities entail significant "up-front" expenditures, partners will be entitled to large tax deductions in the

also attract investors, especially in light of the high risk of many charitable activities.²⁶

In addition to being an important source of capital, the limited partnership is a particularly appropriate vehicle for conducting charitable activities. The charity, as general partner, will have sole control over the use of the invested funds and can therefore ensure that they will be used for the purpose to which the organization is dedicated.²⁷ In addition, the limited partnership agreement can be drawn to relieve the general partner of any obligation to repay, out of its own account, the funds invested by the limited partners.²⁸

B. *The IRS' Position on the Participation of Charities in Limited Partnerships*

The IRS has taken inconsistent positions on whether a section 501(c)(3) organization may participate as a general partner in a limited partnership without losing its section 501(c)(3) status. In several private letter rulings, the IRS has said that section 501(c)(3) hospitals may form limited partnerships with doctors to build medical office buildings for the doctors' use without jeopardizing the hospitals' tax exemptions or their ability to re-

partnership's early years. *See, e.g., id.* § 162 (trade or business expenses); *id.* § 174 (research and experimental expenditures). When added to deductions frequently made available through accelerated depreciation and credits such as the Investment Tax Credit, individual partners will frequently be able to recover the cost of their investment very quickly, thereby increasing their rates of return. *See id.* § 46 (investment tax credit); *id.* §§ 167, 168 (accelerated depreciation). Furthermore, when allocated deductions and credits exceed the partners' income from the partnership, they may be utilized to offset income from other sources and reduce federal tax liability, thereby increasing the rate of return on the partnership investment. Finally, in many instances the gain from the sale of a limited partnership interest may be taxed as capital gain rather than ordinary income. *See id.* § 741. *See generally* W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* (1977) (describing taxation of partnerships).

26. "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." UNIF. LIMITED PARTNERSHIP ACT § 7, 6 U.L.A. 582 (1969); *see also* REV. UNIF. LIMITED PARTNERSHIP ACT § 303(a), 6 U.L.A. 224 (Supp. 1984) ("[A] limited partner is not liable for the obligations of a limited partnership unless . . . he takes part in the control of the business.").

27. To retain their limited liability, limited partners may not take part in the control or management of the partnership. The Uniform Act restricts the rights of limited partners to the right to be informed and the right to petition for dissolution. *See* REV. UNIF. LIMITED PARTNERSHIP ACT § 303, 6 U.L.A. 224 (Supp. 1984); UNIF. LIMITED PARTNERSHIP ACT § 10, 6 U.L.A. 590 (1969). The general partner's control over the limited partnership is typically much greater than it would be in either a general partnership or a joint venture.

28. *See* *Lanier v. Bowdoin*, 282 N.Y. 32, 38, 24 N.E.2d 732, 735 (1939) ("[T]he partners of either a general or limited partnership, as between themselves, may include in the partnership articles any agreement they wish concerning the sharing of profits and losses, priorities of distribution . . . and other matters."). The charity, however, will still have unlimited liability with respect to partnership obligations to third parties. *See* UNIF. LIMITED PARTNERSHIP ACT § 9, 6 U.L.A. 586 (1969) (general partner in a limited partnership subject to all liabilities of partnership with no limited partners); *Kitchell Corp. v. Hermansen*, 8 Ariz. App. 424, 446 P.2d 934 (1968) (general partner may be liable for all debts of limited partnership).

ceive tax-deductible donations.²⁹ In these rulings, the IRS stated that the partnership activities furthered the hospitals' exempt purposes and only incidentally served the private interests of the doctors.³⁰ The IRS has similarly allowed tax-exempt hospitals to form joint ventures and limited partnerships with affiliated doctors to purchase expensive medical equipment.³¹

In contrast, the IRS has challenged the participation of section 501(c)(3) organizations in limited partnerships whose purposes were to produce theatrical plays³² or to build housing for low- and moderate-income households.³³ The IRS argued that in these cases the nonprofit organization furthered the interests of the limited partners, thereby violating the operational test,³⁴ and that the charity's participation created a

29. IRS Priv. Letter Rul. 83-25,133 (Mar. 22, 1983) *reprinted in* IRS LETTER RULINGS REP. (CCH) No. 330 (June 29, 1983); IRS Priv. Letter Rul. 82-26,146 (undated), *reprinted in* IRS LETTER RULINGS REP. (CCH) No. 280 (July 15, 1982); IRS Priv. Letter Rul. 82-17,022 (Jan. 26, 1982), *reprinted in* IRS LETTER RULINGS REP. (CCH) No. 270 (May 5, 1982).

30. For example, in Priv. Letter Rul. 82-17,022, *supra* note 29, a wholly owned subsidiary of an exempt hospital applied for a § 501(c)(3) exemption. The sole purpose of the applicant was to serve as the general partner of a limited partnership with doctors who practiced at the hospital. The limited partnership would build an office building for those doctors. The general partner would contribute the ground lease to the partnership and the limited partners would contribute the capital. Income from the project would be distributed in proportion to the partners' interests. The IRS approved the applicant's exemption, noting the safeguards built into the arrangement, such as the general partner's contribution being limited to the ground lease. The IRS concluded that although the applicant's activities would serve private interests, they would do so incidentally to the achievement of its exempt purpose.

31. See IRS Priv. Letter Rul. 83-44,099 (Aug. 5, 1983), *reprinted in* IRS LETTER RULINGS REP. (CCH) No. 349 (Nov. 9, 1983) (limited partnership); IRS Priv. Letter Rul. 82-06,093 (Nov. 10, 1981), *reprinted in* IRS LETTER RULINGS REP. (CCH) No. 259 (Feb. 17, 1982) (joint venture).

32. *Plumstead Theatre Soc'y v. Commissioner*, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982). See *infra* pp. 1362-63.

33. In Priv. Letter Rul. 78-20,058, a § 501(c)(3) organization sought to serve as the managing general partner of a limited partnership dedicated to building subsidized housing for low-income senior citizens. The limited partners were to be allowed to receive an annual return on investment no greater than eight percent. The IRS ruled that the applicant would jeopardize its exempt status under § 501(c)(3) if it were to serve as a general partner. See IRS Priv. Letter Rul. 78-20,058 (Feb. 17, 1978), *reprinted in* IRS LETTER RULINGS REP. (CCH) No. 64 (May 23, 1978). The IRS has ruled against § 501(c)(3) organizations' participating as general partners in at least two other instances. In each of these two cases, the IRS reversed its position shortly after suit was brought in federal court. See *Wesley Housing Development Corp. Wins IRS in Major Victory For Nonprofits*, Nat'l Leased Housing Assoc. Bull. 8 (undated); Telephone interview with Virginia Peters, Exec. Dir., Wesley Housing Dev. Corp. (Apr. 1982) (discussing Strawbridge Square, Inc., housing development); Telephone interview with Robert S. Scavone, Esq., McCarter & English (Apr. 1983) (discussing New Community Senior Citizen Housing Corp.).

In a recent private letter ruling, however, the IRS indicated that under certain conditions a charity may act as a general partner of a limited partnership dedicated to building low- and moderate-income housing. See I.R.S. Priv. Letter Rul. 83-42,001 (undated), *reprinted in* IRS LETTER RULINGS REP. (CCH) No. 347 (Oct. 26, 1983) (charity may act as general partner provided that steps are taken to insulate it from conflicts of interest).

34. In *Plumstead Theatre Soc'y v. Commissioner*, the IRS argued:

The question, then, becomes one of the extent to which that venture [a limited partnership to produce a play] served the private interests of the investors. And the record clearly establishes that serving their personal profit purpose was a significant, if not overriding, function of the partnership venture Accordingly, we submit, it necessarily follows that more than an

fiduciary duty to further the private interests of profit-motivated investors, thereby conflicting with section 501(c)(3)'s requirement that the organization operate exclusively for charitable purposes.³⁵

C. *The Plumstead Decision*

To date, only one case, *Plumstead Theatre Society v. Commissioner*,³⁶ has addressed whether the participation of a section 501(c)(3) organization as a general partner in a limited partnership is incompatible with its status as a charity. In *Plumstead*, a nonprofit theater organization in need of additional capital to co-produce a play entered into a limited partnership with profit-motivated individuals. For contributing \$100,000 to the partnership, the two limited partners received a 63½ percent share in any profits or losses resulting from the venture. The IRS argued before the Tax Court that the charity's activities evidenced a substantial commercial purpose and served private interests—both violations of the operational test.³⁷ In rejecting these contentions, the court found that the activities of the Plumstead Theatre Society were clearly distinguishable from those of commercial theater companies and hence did not evidence a substantial commercial purpose.³⁸ In addition, the court ruled that the charity did not serve private interests in violation of the operational test.³⁹ Among the factors which weighed in the Theatre Society's favor were the arm's length nature of the transaction, the lack of any obligation to return the limited partners' capital from the organization's own funds, and the lack of any control by the limited partners.⁴⁰

The *Plumstead* decision stopped short of conferring a broad stamp of approval on the use of limited partnerships by charities. Instead, the court limited its analysis to the facts of the case.⁴¹ It is therefore likely that the

insubstantial part of Plumstead's activities . . . were in furtherance of that nonexempt purpose.

Brief for Appellant at 11, *Plumstead Theatre Soc'y v. Commissioner*, 675 F.2d 244 (9th Cir. 1982).

35. See *id.* at 11-12; IRS Priv. Letter Rul. 78-20,058, *supra* note 33; Gen. Counsel's Mem. 36293; *Wesley Housing Development Corp. Beats IRS in Major Victory For Nonprofits*, *supra* note 33, at 9.

36. 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982).

37. *Id.* at 1328. The court noted, however, that the IRS had abandoned its contention that the partnership arrangement violated the prohibition of inurement of net earnings to private individuals. *Id.* at 1328 n.3.

38. Among the factors used by the Tax Court to differentiate Plumstead Theatre Society from commercial theater groups were its nonprofit character, the emphasis on high standards, its attention to the community, and the objective of promoting new and original productions. *Id.* at 1333.

39. *Id.* at 1333-34.

40. *Id.* It is not readily apparent how the factors enumerated by the Tax Court support the argument that the limited partnership arrangement did not reflect a more than insubstantial purpose to further private interests. Instead, the Tax Court's factors seem more appropriate to a holding that no inurement of net earnings to private individuals or shareholders exists.

41. "We find this arrangement, limited to one play produced by petitioner, is no more intrusive or

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IRS will continue to challenge charity participation in limited partnerships.⁴²

III. CHARITIES, LIMITED PARTNERSHIPS, AND TAX POLICY

As long as a charity takes certain precautions to avoid conflicts of interest and transactions with parties who control its operations, it should be permitted to serve as general partner of a partnership dedicated to furthering exempt purposes.

A. *Third Party Benefits and the Operational Test*

Many of the IRS objections to charities serving as general partners stem from adherence to an operational test that sometimes fails to focus on factors relevant to whether a section 501(c)(3) organization uses its resources in an appropriate manner to further charitable objectives. Following a description and critique of the current application of the operational test, this section will propose an approach for analyzing whether benefits accruing to unrelated individuals as a by-product of a charity's activities violate the principles underlying section 501(c)(3). This approach will then be applied to the participation of charities in limited partnerships.

1. *Current Application of the Operational Test*

Under the operational test, a court must examine an organization's activities, from which it will infer one or more purposes.⁴³ If any purpose is judged to be more than insubstantial and non-exempt, the organization will lose its section 501(c)(3) status. Where one activity furthers both exempt and non-exempt purposes, courts will revoke or deny the organization's section 501(c)(3) status if the non-exempt purpose is judged to be more than insubstantial.⁴⁴ For example, in *Better Business Bureau v.*

indicative of private interests than the contractual, percentage arrangement approved of in *Broadway Theatre League v. United States*” *Id.* at 1334. In *Broadway Theatre League*, 293 F. Supp. 346 (W.D. Va. 1968), the court held that a contractual relationship under which a theatrical booking agent received a percentage of a charity's membership dues neither violated the operational test nor constituted prohibited inurement of net earnings to shareholders or individuals.

42. Kaplan, *Real Estate Opportunities For Tax-Exempt Organizations: Potential and Pitfalls After Plumstead Theatre*, 61 TAXES 291, 302 (1983) (“What is reasonably certain is that the IRS will most likely continue to challenge the *Plumstead Theatre* type of transaction.”).

43. See *B.S.W. Group v. Commissioner*, 70 T.C. 352, 357 (1978) (“Under the operational test, the purpose towards which an organization's activities are directed, and not the nature of the activities themselves, is ultimately dispositive of the organization's right to be classified as a section 501(c)(3) organization exempt from tax under section 501(a).”).

44. See *Copyright Clearance Center v. Commissioner*, 79 T.C. 793, 803-07 (1982) (copyright clearinghouse served substantial non-exempt purpose); *Kentucky Bar Found. v. Commissioner*, 78 T.C. 921, 926 (1982) (non-exempt purposes of bar association insubstantial); *Ann Arbor Dog Training Club v. Commissioner*, 74 T.C. 207, 212-13 (1980) (dog training is substantial non-exempt purpose).

United States,⁴⁵ the Supreme Court rejected the application for tax-exempt status⁴⁶ of an organization dedicated to improving business methods and educating the public. The Court held that the same activities that furthered the exempt purpose of education also furthered the non-exempt purpose of benefiting the private business community. It did not matter that the non-exempt purpose was not the primary purpose of the organization; as long as it was a substantial one, it constituted a violation of the operational test.⁴⁷

Under the current operational test, when unrelated third parties receive benefits from a charity's activities, a court must determine whether the benefits reflect a substantial non-exempt purpose.⁴⁸ In administering the operational test, the IRS and the courts will sometimes consider the magnitude of the private benefit to be determinative,⁴⁹ while in other instances, if either the IRS or the court deems the private benefit necessary to the achievement of an exempt purpose, the private benefit is considered insubstantial regardless of its size.⁵⁰

2. Applying the Operational Test to Third Party Benefits

Current application of the operational test may be faulted on at least two grounds. First, inferring purposes from activities is inherently subjective and imprecise. Thus, the current operational test is an open invitation to make decisions based more on intuition than on analysis. Second, once

45. 326 U.S. 279 (1945).

46. The petitioner in *Better Business Bureau* applied for an exemption from social security taxes under former § 811(b)(8) of the Social Security Act. The provisions exempting charities from the Social Security tax were very similar to those exempting charities from federal income taxation. Compare I.R.C. § 501(c)(3) (1982) with Social Security Act, Pub. L. No. 74-271, § 811(b)(8), 49 Stat. 620, 639 (1935).

47. The Court held: "In this instance in order to fall within the claimed exemption, an organization must be devoted to educational purposes exclusively. This plainly means that the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes." 326 U.S. at 283.

48. See, e.g., *Goldsboro Art League v. Commissioner*, 75 T.C. 337, 344-45 (1980) (organization running art gallery which sold paintings and distributed 80% of proceeds to artists did not evidence substantial private purpose); *Christian Stewardship Assistance v. Commissioner*, 70 T.C. 1037, 1043-44 (1978) (organization providing financial counseling for donors to charities failed operational test due to more than insubstantial purpose of benefiting private individuals).

49. For example, in Gen. Counsel's Mem. 38497, the IRS stated that an organization which provided financial assistance to minority entrepreneurs did not violate the operational test since the benefit to individuals who themselves are not the proper objects of charity would be limited. "As we have previously stated, section 1.501(c)(3)-1(d)(1)(ii) of the regulations, which requires operation for public purposes, is satisfied only if the private benefit yielded by the activity in question is qualitatively [sic] and quantitatively incidental to the overall public benefit conferred by the activity." (emphasis added). *Id.*

50. See, e.g., *Broadway Theatre League*, 293 F. Supp. at 355 (payment to booking agent of percentage of § 501(c)(3) organization's membership dues does not violate operational test); *Science & Research Found. v. United States*, 181 F. Supp. 526, 528-29 (S.D. Ill. 1960) (extensive contractual relations with publisher do not jeopardize § 501(c)(3) status); *Goldsboro Art League*, 75 T.C. at 344-45 (art gallery distributing 80% of proceeds to artists did not violate operational test).

a court finds a suspected non-exempt purpose, a similarly standardless inquiry begins to determine whether the alleged purpose is more than insubstantial. Because of the confusion inherent in the operational test, charities cannot plan their activities with confidence that the IRS will not challenge their section 501(c)(3) status. The inconsistent stance of the IRS regarding charities' participation in limited partnerships is just one manifestation of the uncertainty surrounding the operational test.

The operational test is particularly ill-suited for dealing with limited partnerships, where activities in furtherance of charitable objectives also generate benefits for unrelated private parties.⁵¹ Absent irrational behavior or fraudulent motives, those in control of charities have little incentive to benefit unrelated individuals or entities. Therefore, inferring a specific purpose to benefit private individuals merely from the existence of large or potentially large pecuniary benefits flowing to these persons is unwarranted. In most instances these benefits will merely be the by-product of a charity's purchasing the goods and services it requires.

The IRS has tried repeatedly to deny section 501(c)(3) status to non-profit organizations on the ground that they possess a more than insubstantial purpose to benefit unrelated parties. Despite these attempts, courts have usually recognized that such benefits do not, by themselves, prove a non-exempt purpose.⁵² These benefits are usually characterized as incidental to the achievement of the charity's exempt purpose rather than indicative of a separate, substantial non-exempt objective.⁵³ Therefore, both logic and precedent support the adoption of a presumption that the flow of benefits to unrelated private parties as a result of activities that further a charity's exempt purpose does not constitute a substantial non-exempt purpose and therefore does not violate the operational test. This presumption should apply regardless of the magnitude of the benefits to third parties.⁵⁴

51. Unrelated private parties are those persons who do not fall within the ban on inurement of net earnings to private shareholders and individuals. *See infra* note 69.

52. *See* cases cited *supra* note 50. The IRS has acknowledged that in certain factual settings, benefits to unrelated individuals do not constitute a substantial non-exempt purpose. *See, e.g.*, Rev. Rul. 73-313, 1973-2 C.B. 174, 176 (organization that constructed and subsidized private medical facilities in order to lure physician to isolated rural community did not violate operational test); Rev. Rul. 69-383, 1969-2 C.B. 113 (radiologist not in control of hospital may receive a fixed percentage of his department's revenues).

53. *See Goldsboro Art League*, 75 T.C. at 345 ("[P]etitioner's sales activities [sic] are incidental to its other activities . . .").

54. The presumption that third-party benefits generated by charitable activities do not constitute a substantial, non-exempt purpose may be rebutted by evidence indicating that the intent of those in control of the charity was to benefit private parties rather than the public.

3. *Supplementing the Operational Test*

Although the flow of benefits to unrelated individuals may not reflect an intent to benefit those parties, it may indicate that the charity is wasting its resources.⁵⁵ The waste of a charity's resources violates a central premise underlying the charitable income tax exemption and the tax deduction for charitable donations: The activities of private charities lessen the burdens of government and ultimately save it money.⁵⁶ Section 501(c)(3)'s requirements that a charity be operated exclusively for exempt purposes and that the charity's net earnings not inure to the benefit of private individuals or shareholders⁵⁷ serve to maximize the beneficial impact of the government subsidy and thus reflect a concern that charitable resources not be wasted.⁵⁸

Therefore, the federal government has a legitimate interest in prohibiting third-party benefits when they constitute a waste of the charity's resources. The waste standard would operate not as a replacement for the operational test, but as an adjunct to it.⁵⁹ If the IRS could prove that the benefits result from activities that waste the charity's assets, the organization would be denied section 501(c)(3) status.

The IRS might have difficulty proving that a charity's activities squandered assets in violation of the waste standard. Many frequently used indicators of good management, such as fair market value and common bus-

55. This waste may occur either through faulty design of the charity's programs or through mismanagement of day-to-day operations. For example, persons with whom a charity contracts for goods or services may earn unusually large profits merely because those in control of the charity may be mismanaging its affairs, leading it to pay inflated prices for the goods and services it needs.

56. See *supra* note 16.

57. The inurement prohibition also functions to encourage donors to contribute private funds for public purposes. Hansmann calls the prohibition on distribution of a nonprofit organization's net earnings to persons who maintain control over that organization the "nondistribution constraint." See Hansmann, *supra* note 6, at 838. In his theory of the role of the nonprofit sector, he argues that nonprofit entities emerge to deal with situations of market failure where competition is insufficient to stop profit-motivated entities from charging excessive prices for inferior goods. *Id.* at 843-44. The nondistribution constraint is "the essential characteristic" that enables nonprofit organizations to overcome problems of market failure. *Id.* at 873. The absence of any distribution of profits to persons in control of the nonprofit organization destroys any incentive on the part of the organization to charge uncompetitive prices. *Id.* at 844.

Hansmann argues that market failure would occur in the absence of the nondistribution constraint for many charitable activities. Contributors to organizations designed to assist needy persons usually have no connection to the recipients of assistance and therefore little opportunity to monitor and police the services provided. An organization not subject to the nondistribution constraint would have a strong incentive to divert contributions to its owners or controlling shareholders. The nondistribution constraint (in the case of § 501(c)(3) organizations—the inurement prohibition) eliminates this incentive and therefore enables the contributor to entrust the organization with his charitable gift. *Id.* at 847.

58. Cf. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 434 (1960) (arguing that public sector must minimize waste of charitable assets).

59. The waste standard may also be used as an adjunct to the operational test where no benefits to private parties are at issue. The policies that support minimizing the waste of a charity's assets in the third party benefit context apply with equal strength to other activities of charities.

iness standards, may have limited value when applied to the operations of charities.⁶⁰ Moreover, when courts do apply such measures, they may lack the competence to judge whether the organization has wasted its assets.

The burden of proof that the waste standard would place upon the IRS, however, is not insurmountable. The IRS would be able to monitor the activities of a section 501(c)(3) organization through both applications for exemption and the annual informational returns required under the Internal Revenue Code, in much the same way as it now detects whether substantial non-exempt purposes exist;⁶¹ the waste standard simply requires the IRS to go one step further and demonstrate that benefits accruing to the non-exempt third parties detract from the organization's charitable mission by wasting its resources.

In addition, the IRS will not be the sole guarantor of a charity's effective management. Both market forces and legal sanctions encourage charities to conserve their resources. Charities that have records of efficient operation and achievement of charitable goals will more easily attract donations and investor capital. Furthermore, directors or trustees who mismanage the charity's assets may be liable under state law for violation of the fiduciary duty of care they owe to the organization.⁶²

A presumption that benefits to third parties do not evidence a substantial non-exempt purpose coupled with a requirement that the benefits not result from a waste of the charity's assets will not necessarily be more lenient than the current application of the substantiality test. Despite the emphasis on the magnitude of private benefit implied by the substantiality test, many courts ignore the size of the private benefit altogether and concentrate instead on whether the benefit was a by-product of an activity in

60. In some instances, there will be nothing with which to compare the activities of charitable organizations. For example, charitable organizations may become involved in endeavors that other organizations have neglected due to low profitability or high risk. Therefore, there may be no standard against which to judge whether the return to investors in the activity is reasonable. The quality of a charity's output will also be a factor bearing on the waste standard. In some instances a § 501(c)(3) organization may form to provide services of a higher quality than is provided by non-charitable organizations. Determining whether these high quality services result from a waste of resources might be difficult for either the IRS or courts to judge.

61. In order to receive federal tax exemption, most nonprofit organizations must file an application with the IRS. This application requires information describing the organization's activities, a copy of its articles of organization and bylaws, and a financial statement showing its assets, liabilities, receipts, and disbursements. The IRS may request additional information which it deems necessary. Treas. Reg. § 1.501(a)-1(a)(3) (1960). For a description of the application process, see B. HOPKINS, *supra* note 8, at 547-66. Most exempt organizations must also file annual informational returns with the IRS. The return requires the exempt organization to state all items of income, receipts, and disbursements. I.R.C. § 6033(a)(1) (1982).

62. See, e.g., *Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974) (trustees of charity held liable for mismanagement and self-dealing); *Lynch v. John M. Redfield Found.*, 9 Cal. App. 3d 293, 88 Cal. Rptr. 86 (1970) (directors liable for mismanagement of charity's assets).

furtherance of exempt purposes.⁶³ Therefore, in many instances, the additional requirement proposed above—that the third-party benefits not constitute a waste of the charity's assets—will toughen, rather than relax, the standard, consistent with the policies underlying section 501(c)(3).

Charities should not lose their section 501(c)(3) status merely because their participation in limited partnerships generates benefits for their limited partners. As long as the partnership's activities further charitable objectives, benefits to the unrelated investors should be presumed not to indicate a substantial, non-exempt purpose under the operational test. The charity's participation as a general partner does not necessarily waste assets dedicated to charitable purposes. To the contrary, the partnership activities may well further charitable purposes. Without access to private capital, the charity might not be able to carry out its exempt purpose, whether it be producing plays, constructing housing, or building hospitals.⁶⁴ Far from wasting foregone tax revenues or donated gifts, the section 501(c)(3) organization is, through the limited partnership, able to harness private funds for its public purpose. As long as the returns to the limited partners are within the range of returns for similarly risky projects, it is unlikely the IRS would be able to prove such an arrangement to be a waste of the charity's resources.⁶⁵

B. *Conflict of Interest and Private Inurement*

Two other objections to charities' serving as general partners center on the extent of the limited partners' control over the operations of their general partner. First, the IRS has argued that the nonprofit general partner's fiduciary obligation⁶⁶ to further the private interests of its limited partners may create a conflict of interest and force the charity to engage in practices that conflict with its public, charitable purpose.⁶⁷

63. See cases cited *supra* note 50.

64. See *Plumstead Theatre Soc'y*, 74 T.C. at 1328; Brief for Appellee at 48-49, *Plumstead Theatre Soc'y*, 675 F.2d 244 (9th Cir. 1982); Black, *Nonprofit Firm Sells Shares To Finance Housing Project*, *Christian Science Monitor*, Feb. 11, 1983, at 16, col. 3.

65. Excessive returns to limited partners would indicate a waste of charitable resources since those funds would otherwise belong to the charity and be available to further its exempt objectives.

66. A general partner is under a fiduciary duty to protect the interests of its limited partners. See *Riviera Congress Assoc. v. Yassky*, 18 N.Y.2d 540, 547, 223 N.E.2d 876, 879, 277 N.Y.S.2d 386, 392 (1966); *Meinhard v. Salmon*, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (1928); Beane, *The Fiduciary Relationship of a Partner*, 5 J. CORP. LAW 483 (1980).

67. For example, in Gen. Counsel's Mem. 36293, the IRS examined the participation by a § 501(c)(3) applicant in a limited partnership to build and operate subsidized housing. Its opinion that the application should be rejected rested in part on the charity's role as general partner:

Such participation would be *inherently incompatible* with being operated exclusively for charitable purposes within the meaning of Code § 501(c)(3).

By agreeing to serve as the general partner of the proposed housing project, the Corporation would take on an obligation to further the private financial interests of the limited partners. Since the promotion of those private interests would tend to foster operating and maintenance

A second objection concerns section 501(c)(3)'s prohibition on the inurement of a charity's net earnings to private individuals and shareholders. The inurement clause is widely believed to be aimed at individuals who maintain some control over a charity and are thus in a position to divert its revenues to their own purposes.⁶⁸ Both treasury regulations and case law support the view that the clause is limited to a prohibition on self-dealing by insiders of the charity such as officers, directors, and large contributors.⁶⁹ A minority view, however, advances the proposition that the proscribed inurement of net earnings also includes benefits received by non-insider third parties who maintain some level of control or influence over the charity.⁷⁰

An IRS attorney who adheres to this minority position on inurement argued in a recent article that the fiduciary duty owed by the charity to its partners is a legally enforceable obligation and therefore constitutes "considerable control" by the limited partners over the organization.⁷¹ Under this theory, the income earned by limited partners of the charity therefore constitutes an inurement of net earnings.

The inurement objection to charities' serving as general partners, like the concern over conflict of interest, is premised on the view that private investors have control over the actions of charities by virtue of the fiduciary duty owed by one partner to another. Even if one were willing to accept this proposition, these duties can be modified or waived by the

practices favoring the equity holdings of the limited partners to a greater extent than would otherwise be justifiable on the basis of reasonable financial solvency, the Corporation's assumption of a duty to promote such interests in its capacity as general partner would necessarily create a conflict of interest that is legally incompatible with its being operated exclusively for charitable purposes. (emphasis added)

Gen. Counsel's Mem. 36293. *But see* IRS Priv. Letter Rul. 83-42,001, *supra* note 33 (permitting § 501(c)(3) organization to serve as general partner in low-income housing limited partnership).

68. *See* B. HOPKINS, *supra* note 8, at 211; P. TREUSCH & N. SUGARMAN, *TAX EXEMPT CHARITABLE ORGANIZATIONS* 166 (2d ed. 1983).

69. Treas. Reg. § 1.501(a)-1(c) (1960) defines "private shareholder or individual" as "persons having a personal and private interest in the activities of the organization." *See* Science and Research Found. v. United States, 181 F. Supp. 526, 529 (S.D. Ill. 1960) (contractual relationship with book publisher not inurement); Goldsboro Art League v. Commissioner, 75 T.C. 337, 345-46 (1980) (payment of sales proceeds to artists not inurement); People of G-d Community v. Commissioner, 75 T.C. 127, 133 (1980) (emphasizing that "private shareholder or individual" does not refer to unrelated third parties); *see also* R. DESIDERIO & S. TAYLOR, *supra* note 16, at § 12.04, at 12-10 (inurement clause does not refer to unrelated parties).

70. In *EST v. Commissioner*, 71 T.C. 1067 (1979), the court denied a tax exemption to a corporation formed to train people in a behavioral therapy called Erhardt Seminar Training (EST). The petitioner had entered into an agreement with the for-profit corporation that controlled the rights to EST programs in which the for-profit corporation would receive 50% of the petitioner's gross proceeds in return for providing trainers, managers, and materials. The court held that the petitioner operated for the purpose of subsidizing a profit-seeking corporation and therefore failed the operational test. Although never explicitly stated, there is considerable language in the decision to indicate that the court also found proscribed inurement of net earnings since the for-profit corporation "exerts considerable control over petitioner's activities." 71 T.C. at 1080.

71. Kaplan, *supra* note 42, at 300-01.

partners themselves.⁷² By carefully drafting the partnership agreement,⁷³ a charity can free itself from any obligation to take actions contrary to its charitable purpose.⁷⁴

C. *Unfair Competition and the Transfer of Tax Benefits*

Concerns that reach beyond issues of qualification under section 501(c)(3) may underly the IRS' ambivalent attitude toward charities that serve as general partners. The IRS may fear that the charities' activities would harm unrelated parties and place them at a competitive disadvantage in the marketplace for investors' capital. The IRS may also suspect that charities and private investors use limited partnerships primarily to create tax-avoidance opportunities. Neither of these concerns, however, warrants barring charities from serving as general partners.

72. See *Riviera Congress Assoc. v. Yassky*, 18 N.Y.2d 540, 548, 223 N.E.2d 876, 880, 227 N.Y.S.2d 386, 392 (1966) ("[P]artners may include in the partnership articles practically 'any agreement they wish' . . . and, if the asserted self-dealing was actually contemplated and authorized, it would not *ipso facto*, be impermissible and deemed wrongful."); *Bassan v. Inv. Exch. Corp.*, 83 Wash. 2d 922, 925, 524 P.2d 233, 236 (1974). But cf. Note, *Disclosure, Fairness and Substantive Administrative Regulation of A General Partner's Fiduciary Duty in a Real Estate Limited Partnership*, 50 WASH. L. REV. 977, 990-91 (1975) (suggesting that courts may in future analyze fairness of transaction to limited partners).

73. A recent private letter ruling admits that the role of general partner "should not per se result in denial of section 501(c)(3) status." See IRS Priv. Letter Rul. 83-42,001, *supra* note 33. The IRS permitted a charity to serve as the general partner of several limited partnerships formed to construct federally subsidized low-income housing. The IRS "closely scrutinized" the proposed arrangement and determined that the § 501(c)(3) organization had sufficiently insulated itself from potential conflicts of interest. *Id.* In particular, the IRS noted that the partnership agreement restricted participation by the limited partners and that the federal government set limits on tenant rents and on partnership distributions. *Id.*

A further safeguard against private investors' gaining control over the operations of the § 501(c)(3) general partner is the nature of the limited partnership arrangement itself. Of all types of joint activity, the limited partnership form is the most restrictive in terms of the control it allows limited partners. In return for limited liability, limited partners relinquish any right to participate in the management of the partnership. See *Lichtyger v. Franchard Corp.*, 18 N.Y.2d 528, 535-36, 223 N.E.2d 869, 873, 277 N.Y.S.2d 377, 383 (1966); UNIF. LIMITED PARTNERSHIP ACT § 7, 6 U.L.A. 582 (1969); Feld, *The Control Test For Limited Partnerships*, 82 HARV. L. REV. 1471, 1472-73 (1969).

74. Issues of control and conflict of interest are not confined to the limited partnership vehicle; similar problems are currently facing tax-exempt universities and corporate sponsors of research. Increasingly, profit-motivated entities provide funds to educational institutions, and, in exchange, utilize their faculty's research expertise for commercial purposes. Because the two parties have similar, but not identical, interests and goals, conflicts will arise over issues such as the choice of research projects, the publicity of research findings, and the ownership of patent rights. Regardless of whether the formal structure of the relationship between the two entities is governed by a contract for services or a limited partnership agreement, the university must insulate its educational purpose from undue commercial influence. See NAT'L SCIENCE FOUND., *UNIVERSITY-INDUSTRY RESEARCH RELATIONSHIPS* 21 (1982); *Business and Universities: A New Partnership*, BUS. WEEK, Dec. 20, 1982, at 58; *Business Goes To College*, FORBES, Oct. 11, 1982, at 196; *Conflict of Interest on the American Campus*, ECONOMIST, May 22, 1982, at 107; Sanger, *Corporate Links Worry Scholars*, N.Y. TIMES, Oct. 17, 1982, at F4, col. 3.

1. *Unfair Competition*

Whenever a tax-exempt organization carries on commercial activities, charges of unfair competition are bound to arise.⁷⁵ Some might argue that a section 501(c)(3) general partner possesses an unfair advantage in attracting capital for its projects: It can use its tax exemption and ability to attract tax-deductible donations to offer limited partners a more lucrative distribution of the tax benefits and income from a project than could a profit-motivated general partner.⁷⁶ Section 501(c)(3) general partners would thus unfairly compete with their for-profit counterparts.

Concerns about unfair competition, however, do not provide a persuasive rationale for prohibiting charities from serving as general partners. First, charities will often not be competing with profit-motivated firms for investor capital.⁷⁷ Second, there is no evidence to indicate that a charitable organization's preferential tax treatment makes it likely to offer terms any more advantageous to investors than those offered by profit-motivated general partners.⁷⁸ Third, even if it could be shown that a section 501(c)(3) organization did tend to offer better terms, the unfair competition argu-

75. The controversy over unfair competition by tax-exempt organizations climaxed in 1950 with the passage of the Unrelated Business Income Tax, which taxes exempt organizations on income from "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 501" IRC § 513(a) (1976). Among the reasons for the tax was Congress' fear that the tax exemption granted to certain nonprofit organizations under § 501(c) would enable them to compete unfairly with profit-motivated, taxable businesses by allowing them to accumulate capital for expansion and undercut the prices of their competitors. See S. REP. NO. 2375, 81st Cong., 2d Sess. 28, *reprinted in* 1950 U.S. CODE CONG. & AD. NEWS 3053, 3081.

76. For projects which require the same capital investments and return the same income streams, the tax-exempt organization will have a higher return on investment than will the taxable entity. In times of scarce capital, the tax-exempt organization may be able to make a higher bid for investment dollars due to the greater net (after-tax) income it will receive. The ability of the charity to receive tax deductible donations provides an additional cushion allowing the nonprofit organization to make the terms of the transaction even more attractive to investors.

77. Many activities carried out by charities are unattractive to profit-motivated firms. See *supra* note 24.

78. Several scholars have criticized, on theoretical grounds, allegations that tax-exempt organizations compete unfairly. For example, Kaplan argues that the contention that tax-exempt organizations charge lower prices for their output than do taxable entities has not been proven. He also doubts whether tax-exempt organizations would be likely to initiate a price war. See Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 COLUM. L. REV. 1430, 1464-66 (1980). Other commentators argue that because the corporate income tax is levied only on profits, it will not affect total output under competitive conditions since industries will produce until the cost of another unit of output equals the additional revenue it will bring. See Klein, *Income Taxation and Legal Entities*, 20 UCLA L. REV. 13, 62 (1972); Comment, *Preventing the Operation of Untaxed Business By Tax-Exempt Organizations*, 32 U. CHI. L. REV. 581, 591 (1965). But cf. Hansmann, *supra* note 23, at 564-65 (hypothesizing that "because the managers of a nonprofit have no direct financial stake in the residual earnings of the enterprise, they may be willing to agree to a more generous interest rate on borrowed money than necessary, simply to avoid the personal effort involved in seeking out a better deal"); Rose-Ackerman, *supra* note 24, at 1026-36 (unfair competition may occur under oligopolistic market conditions or when nonprofit organizations enter a particular market unanticipated by profit-motivated competitors).

ment cannot be restricted to investment opportunities offered by charities as general partners. If unfair competition by charities is a problem, it is one that bears on almost all transactions by charities in the marketplace. Since charitable organizations must be allowed to carry on commercial transactions in the open market to accomplish their charitable goals, there is no principled basis for singling out limited partnership activities for disqualification. Finally, as long as the activity that leads to "unfair competition" is in furtherance of the charity's exempt purpose, congressional policy, as reflected by the Unrelated Business Income Tax, is to allow the activity to go forward unimpeded.⁷⁹

2. *Transfer of Tax Benefits*

Some investors join with charities in limited partnerships to take advantage of the tax benefits generated by the partnership's activities.⁸⁰ Similarly, charities may sometimes seek out limited partners to utilize the tax benefits that they might otherwise be unable to use because of their non-taxable status.⁸¹ If one views the federal tax provisions exempting charities from the corporate income tax and allowing them to receive deductible donations as government subsidies,⁸² the additional funds made available through the transfer of tax benefits to the limited partner may constitute a "third subsidy" to charities. This additional subsidy to charities may undercut one of the principal justifications for according them preferential tax treatment—that charities save the public sector money by lessening the burdens of government.⁸³

The question whether tax-exempt organizations should be able to

79. IRC § 513(a) (1982) exempts from the Unrelated Business Income Tax those activities that are "substantially related" to the pursuit of the organization's exempt purpose regardless of any competition with profit-motivated entities.

80. For example, investors in low-income housing syndications are typically motivated by the prospect of receiving significant deductions for accelerated depreciation and interest payments.

81. Due to its exempt status, a charity cannot directly utilize the tax deductions generated by its activities. Entering into a limited partnership permits it to raise additional capital in return for a portion of the tax deductions and income generated by the project.

82. Professor Surrey views the deduction allowed by I.R.C. § 170 for contributions to § 501(c)(3) organizations as a tax expenditure or subsidy to the donor's personal charitable choices. See S. SURREY, *supra* note 3, at 224-25. Under this theory, the contribution should be treated as an item of consumption comparable to other personal expenditures. Several other commentators, however, have argued that deducting charitable donations from gross income is appropriate in computing taxable income and therefore not a subsidy. See Bittker, *supra* note 3, at 56-62; cf. Andrews, *supra* note 18, at 355-56 (arguing that donations to charities should not be considered consumption of the donor).

83. It should be noted that the limited partnership arrangement may sometimes provide more money to the Treasury in terms of tax revenue than it costs in "transferred" tax benefits. If the charity were to carry out its activities alone, the income it earned would not be taxable. The limited partners' share of the income from the same activities, however, would be taxable. Therefore, where tax revenue received from the limited partners exceeds the tax revenue lost through the transfer of deductions, the Treasury may receive more than if the activity had been carried out by the charity alone.

transfer tax benefits to taxable entities has become a matter of recent congressional concern. Because of increased fiscal pressures and the accelerated depreciation provisions of the Economic Recovery Tax Act of 1981,⁸⁴ federal, state, and local governments, as well as other tax-exempt entities, have used sale-leaseback transactions to take advantage of tax benefits.⁸⁵ As a result of several well-publicized leasing transactions,⁸⁶ federal legislation to curb the practice appears imminent.⁸⁷

Concern about the potential for a transfer of tax benefits should not, however, lead to the invalidation of a charity's participation as a general partner in a limited partnership. In most situations, the limited partners will be investing most of the capital for the partnership's activities and

84. I.R.C. § 168 (1982). In 1981, in an effort to stimulate investment in plants and equipment, Congress enacted § 168 which provides for the adoption of the Accelerated Cost Recovery System (ACRS). For property placed in service after 1980, the cost of the property is recovered over a much shorter period than prior depreciation schedules tied to useful life had provided. For example, prior to the 1981 Act, real property was depreciated over a period of up to forty years. Under the ACRS schedule, the cost of real property may be recovered over fifteen years. Since a current deduction is usually worth more than a deferred deduction, Congress anticipated that adoption of ACRS would spur investment in depreciable assets. See S. REP. NO. 144, 97th Cong., 1st Sess. 48, *reprinted in* 1981 U.S. CODE CONG. & AD. NEWS 105, 153.

85. A typical sale-leaseback will consist of a tax-exempt entity selling equipment or other property to a taxable entity which is able to deduct depreciation and interest expenses, and where available, claim an investment tax credit. The tax-exempt organization then leases the property back, frequently at a below market rental that reflects a portion of the tax benefits.

86. For example, in recent years the Navy has leased ships from private owners rather than procuring them itself. See STAFF OF JOINT COMM. ON TAXATION, 98TH CONG. 1ST SESS., TAX ASPECTS OF FEDERAL LEASING ARRANGEMENTS 4-8 (Joint Comm. Print 1983). In addition, local governments have sold and leased back public buildings such as museums and performing arts centers. See CONGRESSIONAL BUDGET OFFICE, TRENDS IN MUNICIPAL LEASING 7-9 (1983) (report prepared for Subcomm. on Oversight of House Ways and Means Comm.). Private colleges and universities have leased back entire campuses to earn additional revenues. See *id.* at 8; *College To Try Leasing To Wipe Out Its Debts*, Wash. Post, Apr. 20, 1983, at A12, col. 1.

87. A bill recently passed by the House of Representatives is designed to curb practices in which tax-exempt entities use properties that are owned for tax purposes by taxable entities. The bill reduces the incentives for taxable entities to enter into such transactions by lengthening the recovery periods over which depreciation deductions must be taken for property designated "tax exempt use property." For example, whereas real property owned and occupied by taxable entities is subject to a fifteen year recovery period under ACRS, see *supra* note 84, the same property would be subject to a forty year recovery period if it fell within the definition of tax-exempt use property. Tax-exempt use property primarily includes depreciable property leased to tax-exempt entities under long-term leases.

Recognizing that taxpayers could achieve tax results similar to those achieved through sale-leasebacks by owning property in a partnership, the bill provides for treatment that would curb transfers of tax benefits for these transactions too. Under the bill, if a tax-exempt partner does not receive the same share of income or gain as he does of deductions or credits, then that proportion of the property that bears a relation to the tax-exempt entity's share of income or gain will be treated as tax-exempt use property and therefore be subject to an extended recovery period. See H.R. 4170, 98th Cong., 2d Sess., 130 CONG. REC. H2629 (1984).

If H.R. 4170 becomes law, it is likely that its provisions would not substantially affect many transactions in which charities serve as general partners. Many of these partnerships do not own substantial depreciable assets. See *Plumstead Theatre Soc'y v. Commissioner*, 74 T.C. 1324 (1980) (partnership to produce a play). Furthermore, for many of the partnerships that do own depreciable property, the tax-exempt entity's share of partnership income or gain is miniscule. See IRS Priv. Letter Rul. 83-42,001, *supra* note 33 (tax-exempt general partner made nominal or no capital contribution and received management fees only).

therefore should be entitled to any concomitant tax benefits.⁸⁸ Forbidding the participation of the charity as general partner or depriving limited partners of a ratable share of their tax deductions solely because their general partner is a tax-exempt organization would penalize both parties rather than take away an undeserved advantage. If existing safeguards against the shifting of tax deductions are deemed inadequate, a more reasonable alternative would be the enactment of stricter partnership allocation rules, allowing the taxable partners to receive only those tax benefits that bear a direct relationship to their share of capital contributions or income.⁸⁹

CONCLUSION

In many instances a charity may find that joining with unrelated, profit-motivated investors in a limited partnership will be the best method for achieving its charitable purpose. In such instances, as long as the partnership agreement sufficiently protects the section 501(c)(3) organization from potential conflicts of interest and provides for distributions of profit and loss that have economic substance, the charity should be permitted to serve as general partner without jeopardizing its tax exemption.

—*Michael H. Schill*

88. The Code provides a safeguard against abusive tax shelters by requiring that an agreed-upon allocation of income and loss be ignored if the allocation "does not have substantial economic effect." I.R.C. § 704(b) (1982). In such instances, income and losses will be distributed according to the partners' interests in the partnership. Therefore, if it appears that a charity joined with limited partners for the purpose of transferring tax benefits (such as by allocating to the limited partners tax losses that are disproportionate to their capital contributions), then the allocation will be voidable if it does not otherwise meet the substantial economic effect test. See Treas. Reg. § 1.704-1(b), 48 Fed. Reg. 9871 (to be codified at 26 C.F.R. § 1.704-1(b)) (proposed June 23, 1980).

89. This is similar to the approach adopted by H.R. 4170. See *supra* note 87.