



COLLABORATIVE TRANSFORMATION

FOCUS ON INNOVATION CENTERS



TAX EXEMPTION CONSIDERATIONS FOR HHS INNOVATION INVESTMENTS

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As part of their innovation strategies, tax-exempt hospitals and health systems (HHSs) are increasingly finding ways to partner with for-profit businesses as a means of advancing their charitable missions as well as monetizing their intellectual property assets. These arrangements can range from formal joint ventures, to strategic investments, to highly customized contractual arrangements. For-profit capital and collaboration can catalyze the work of a nonprofit HHS but also raise complex tax and other legal issues for Internal Revenue Code (Code) Section 501(c)(3) participants. Navigating these issues and negotiating successful business relationships are critical for the success of the collaboration. Below is a brief overview of the top tax exemption considerations for HHS business and legal teams. While somewhat straightforward to summarize, these issues are often difficult to implement in practice, especially as tax-exempt organizations and their transactions become more complex.

STRUCTURE

There are many different ways for a nonprofit to collaborate with a for-profit counterparty, each with different tax implications, and the approach in a particular situation should be tailored to the [financial resources and goals of both parties](#). By way of example:

- Sponsored research using for-profit capital is producing incredible results at some of the nation's leading nonprofits, including HHS research arms. Licensing intellectual property to a large organization in exchange for a cash royalty stream is the simplest approach. The HHS often provides services in connection with the license, which is perfectly permissible but also raises additional issues that must be considered.
- Alternatively, the HHS can license its IP in exchange for an equity investment in a startup venture, or in exchange for both a current royalty stream and a future potential equity spinoff.
- Beyond IP, an HHS can contribute operating assets or an entire service line to startup with a for-profit partner.
- In some cases, the optimal approach for the parties is to enter into a customized contractual arrangement involving something less than creation of a new legal entity.

CONTROL

Over time, the Internal Revenue Service (IRS) has recognized that joint ventures and other collaborations between nonprofit and for-profit parties can advance tax exempt purposes. A recurring theme in IRS rulings, however, is that the degree of control retained by the tax-exempt over decisions fundamentally related to exempt status is an important factor in assessing tax-exemption compliance. Depending on the structure involved, the negotiation over reserved powers or voting mechanisms will change. Often these constraints come as a surprise to a for-profit counterpart unaccustomed to tax exemption rules so early conversations between legal counsel can keep discussions on the right track. Further, consideration should be given to successful outcomes as well as exit strategies in the event things do not go as planned so the tax-exempt partner is not left out of decision-making on future material changes related to the startup or investment.

VALUATION

Section 501(c)(3) organizations face a variety of limitations under the Code, including the requirement that transactions with for-profit parties occur at fair market value and on commercially reasonable terms. Significant collaboration transactions can be difficult to value; this is where capable third-party advisors can become an important part of the team. Early on in a potential transaction, depending on the nature of the assets being contributed to the startup, thought should be given to whether a formal valuation would be appropriate. A valuation or fairness report prepared by an independent firm can give the HHS board of directors additional confidence that the business terms are reasonable and provide important tax-exemption compliance documentation in the event the transaction is ever challenged by the IRS or state Attorney General, which also regulate nonprofit HHSs. Even where a valuation is not warranted, documenting leadership's diligence and the review process during a transaction is essential.

UNRELATED BUSINESS TAXABLE INCOME (UBTI)

Tax-exempt organizations are increasingly finding themselves owing some tax on their operations, especially after changes made as part of tax reform. As HHSs find creative ways to make the most of their resources, many that have historically shied away from “unrelated business” activities are deciding that these activities have a place within the larger exempt operations. As innovation investments increase, managing UBTI becomes an ongoing exercise and depends on the specific facts of each collaboration. Often advance planning can minimize or eliminate these potential tax burdens.

TAX-EXEMPT BOND IMPACT

HHSs that rely on tax-exempt bonds as a major source of capital face additional limitations. Careful monitoring of activities and drafting of contracts is required in order to minimize activity that can jeopardize bondholders’ tax-exempt interest payments. An innovation venture that involves the use of bond-finance space by private parties must be carefully analyzed regarding control, term length, and economics, and express language must be included in documents to avoid “private use” under IRS rules.

CONFLICTS OF INTEREST

Large, sophisticated exempt organizations and their leadership have many relationships with third parties. An internal protocol that takes a consistent and disciplined approach to identifying, assessing and managing potential conflicts of interest can flag these relationships in advance of an innovation transaction and allow appropriate measures to be taken to preserve independence in key decision-making by the nonprofit organization, including the decision whether to invest or otherwise participate in the deal. In the context of innovation ventures, given the often multiple participants affiliated with the HHS, these issues can result in [significant tax exemption and public relations issues](#).

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