

Charitable Joint Ventures US Regulations force Venture Philanthropy offshore

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Since 9/11, the US regulatory environment for international philanthropy has been, at best, suspicious. This attitude discourages the flow of charitable funds for international projects. International philanthropists are being driven offshore, outside the US, to a more expansive view of charitable purpose. A recent case study involving a promissory food technology highlights the regulatory problems of structuring joint ventures between for-profit and not for-profit organisations. Not for-profit organisations are called "exempt organisations" in this article, meaning that they are exempt from taxation in the US and their home country.

Taloof Patel is a world famous food chemist. He has advanced degrees in chemistry from Institutes of Technology in India and California. His experiments on genetically modified organisms are well regarded. Dr. Patel has developed new strains of moulds and fungi that have promising nutritional value. He received a USD5m offer from a US agri-business organisation, "AgroBiz", to commercialise the discoveries. He also received a "genius grant" of USD350,000 for the same purpose. He wanted to ensure that any new products would be available in developing countries, free from US regulation. However, he was advised that if he were successful in launching any mouldy or fungi foods, he would be sued. Dr. Patel approached us for advice on how best to structure the research, development and commercialisation of the potential new food products.

The desire was to structure the transaction in the US, where joint ventures between exempt and for-profit organisations are increasingly common:

- Partnerships between two exempt organisations
- Exempt organisations making passive investments in for-profit partnerships

- For-profit investments in exempt organisations.

Globalisation has created a flat playing field. Geo-political boundaries do not limit the flow of information or capital, except for US exempt organisations. Several years ago, a US exempt organisation, operating a community hospital, attempted to generate additional income from its profitable x-ray laboratories to subsidise urgent care facilities which were haemorrhaging. It was not permitted.

The regulator of US exempt organisations is the Internal Revenue Service (the "IRS"). The IRS takes its job seriously. The price of exemption in the US is regulation - mountains of it. The IRS recently released a Revenue Ruling (Rev. Rul. 2004-51, 2004-22 IRB 974) that identified the factors that the IRS considers when analysing joint ventures between exempt organisations and others. The IRS listed the factors that it considers would endanger the exempt organisation's tax exempt status or result in unrelated business income tax - a penalty tax imposed on US exempt organisations that stray from the approved regulatory path.

Before 2004 and the issuance of Revenue Ruling 2004-51, the IRS offered little advice regarding whether joint ventures between exempt organisations and for-profit persons would nullify exempt status. After the Revenue Ruling, it is still not clear. There are no "safe harbours" which protect venture capital philanthropy. There are no assurances that Dr. Patel and AgroBiz can fund a research, development and commercialisation project to relieve world-wide hunger without taxation, ie, inside a US exempt organisation.

Under US rules, an exempt organisation is required to act "exclusively for charitable purposes". The IRS defines this phrase very narrowly. The IRS initially barred any participation by an exempt

organisation as a general partner in a joint venture that included private investors as limited partners. The IRS viewed any such partnership as incompatible with the "exclusivity" requirement. The IRS reasoned that there was a conflicting fiduciary duty on the exempt organisation partner to further the financial interests of its for-profit partner. This potential problem was enough to chill such ventures. The IRS reasoned that the "potential for conflict" exposed the assets of the exempt organisation and "could" result in profits of the joint venture being shared with for-profit persons. When Dr. Patel was informed of this, he knew he had a problem in the US.

We advised Dr. Patel that the IRS had approved joint ventures between a hospital and an MRI laboratory, but only if the exempt organisation was in total control. The Revenue Ruling approved a university's distance-learning centres, but only if the university administrators controlled the content and only if incidental assets of the university were involved. We pointed out that another hospital was allowed to use its endowment funds to finance redevelopment of the decaying residential neighbourhood surrounding the hospital in order to provide housing for doctors, staff and students, but the hospital had to be in the housing business, it could not partner with a for-profit land developer. An exempt organisation was permitted to issue participating bonds to for-profit investors to finance low-income housing development, provided that the participation rate was fixed and there was no profit sharing.

Dr. Patel attended a course on Capital Markets at the Milken Global Institute where panel discussions focused on how a US exempt organisation could fund research on promising medical developments and accelerate delivery

systems, but capital had to be passive - venture capital philanthropy was discouraged. US for-profit organisations can lend money to US exempt organisations to re-lend to international micro-finance ventures. US exempt organisations can donate funds to for-profit organisations to fund interest payments prior to securitisation and refinancing underlying community development loans. The capital markets are interested in joint ventures. The IRS is watching with suspicion and with an itchy, regulatory finger.

The IRS issued the Revenue Ruling, but it raised more questions than it answered. Essentially, the IRS recognises the validity of a joint venture between a non-health care exempt organisation and a for-profit entity even where the exempt organisation does not have total control. However, the IRS wants the exempt organisation to retain sufficient control over the substantive activities of the joint venture and wants to make sure that not too many of the exempt organisation's assets are used for this purpose. Without the ability actually to exercise that control, "related" activities may be converted into "unrelated" activities and subject to tax. Moreover, the IRS threatens the exempt organisation joint venturer with the loss of tax-exempt status. If US patent laws are involved, an exempt organisation cannot fund the development or purchases of generic drugs or technologies, eg, to fight AIDS. If any technology is developed at a US educational institution that received US federal educational funds, the university must control exploitation - imagine how the theoretical physicist does that.

Dr. Patel properly concluded that the IRS does not encourage joint venture financing or innovation. The IRS attitude, when combined with the general suspicion towards international grant-making following 9/11, persuaded Dr. Patel that he could not carry out his objectives in the US. Dr. Patel had to go offshore.

We supported Dr. Patel's conclusion to get out of town. We recommended that he go global and structure outside the US. (For Dr. Patel, the issue is food production; for others it is education, micro-finance or medical technology development.) Whatever the social issue, if it has broad international application, it is better to manage the development and exploitation away from IRS regulatory oversight.

Dr. Patel set up a registered, New Zealand, public, charitable trust with the UN World Food Organisation (the "WFO") as the sole beneficiary (the "Trust"). The Trust will be governed by New Zealand law because that is where the mind and management of the institutional trustee reside. The trust agreement provides that, in the event legal

proceedings seek money from Dr. Patel as the developer of the intellectual property (the "IP"), the Trust, or any of its subsidiaries, the Trust migrates to the Cook Islands; mind and management paddle off the mainland. Thus, the Trust had asset protection features that avoid the recently enacted ten-year "look back" on "self-settled" trusts embedded in the US 2005 Bankruptcy Act.

Dr. Patel contributed his IP to the Trust, along with the USD350,000 proceeds from the genius grant. No US income tax deduction was available to Dr. Patel for these donations. A US person (including Dr. Patel, a foreign person resident in the US for more than 183 days) cannot claim an income tax deduction for gifts to foreign charities (geo-political boundaries in a flat world still control). Dr. Patel accepted this result because at the time of the gift, the formulas and research did not have ascertainable value; commercialisation had not been demonstrated. The chemical formulas needed to be refined and tested. There was no US income tax deduction for the USD350,000 cash gift either, but this was acceptable since it was a scholarship/grant and was not taxable to Dr. Patel in the first place. So, Dr. Patel was able to transfer the IP and some cash offshore, without adverse US tax consequence.

The Trust formed a wholly owned non-profit foundation in Switzerland ("SwissChar") to hold, perfect and license IP to be developed in the future. The Trust licensed the IP, which it received from Dr. Patel, to SwissChar. Since this transaction took place outside the US, neither the US nor New Zealand nor Switzerland levied any tax.

SwissChar then entered into a joint venture with AgroBiz. In exchange for agreeing to fund USD5m of research and development, AgroBiz received the exclusive right to 60% of US commercialisation income. Dr. Patel, in exchange for his donation and future services, was given a non-exclusive right to 30% of US commercialisation income and 80% of such income outside the US. SwissChar retained the balance of worldwide income for the benefit of the Trust and its beneficiaries, the WFO. Such a business deal would not be approved in the US because AgroBiz controlled too much of the research, development and commercialisation. Moreover, a donor, Dr. Patel, benefits from the project. US regulations prevent Dr. Patel from contributing cash, IP and services to an exempt organisation and taking back a financial interest in a successful project that may improve the nutrition of the world.

SwissChar, with the approval of AgroBiz, contracted with an Indian university and private software company

to complete the research and conduct the clinical trials. The Indians obtained no intellectual property rights in the new technology; they waived these rights when they agreed to accept fees for services. A US educational institution, however, especially if funded with grants from the US government, is required to retain intellectual property rights. Dr. Patel's Alma Mater had a different attitude. It was interested in new food technologies and collected only fee income.

If the new products are sent to market, the tax consequences to the exempt organisations, SwissChar and the Trust will be as follows:

1. AgroBiz will exploit the food technology in the US pursuant to improved SwissChar IP and share the revenue with SwissChar in the form of a 40% royalty.
2. SwissChar will exploit the technology in the rest of the world and receive a 100% royalty.
3. From US producers using the IP, SwissChar will share its royalty income with Dr. Patel, the Trust and the WFO.
4. From non-US producers, SwissChar will receive a larger royalty income stream to share with Dr. Patel, the Trust and the WFO.

SwissChar will have US source royalty income due to US commercialisation, but under the US-Swiss tax treaty, royalties are remitted tax-free from the US to Switzerland. Royalties from SwissChar to the New Zealand charitable trust are also exempt under the tax treaty between Switzerland and New Zealand. Royalties received by the Trust are exempt from New Zealand income tax because they are foreign source income. Distributions to the WFO would be otherwise taxable to the beneficiary of the Trust, except the WFO is an internationally recognised exempt organisation in both New Zealand and Switzerland.

The economic history of the Patel Food Foundation is being written. Money from the commercialisation of the IP is being accumulated and re-invested into new and better food technology for the cultivation and distribution of perishable moulds and fungi. The development of internationally acceptable food products could not have been carried out in the US. There are too many US regulatory restrictions on joint ventures between exempt organisations and for-profit enterprises. As a result, the offshore world gains an advantage at the expense of US exempt organisations.

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