

PRIVATE VS. PUBLIC BENEFIT

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I. Introduction

At the heart of tax-exempt status under section 501(c)(3) is a seemingly self-evident requirement that a charity be operated for a public, rather than a private, benefit. Despite its core importance, the line between public and private benefit has never been carefully and clearly delineated. In fact, a review of court cases and administrative rulings involving private benefit suggests that the concept shares many of the characteristics of pornography, as defined by US Supreme Court Justice Potter Stewart. Justice Stewart's famous words in Jacobellis v. Ohio, 378 US 184 (1964), "I know it when I see it," can just as easily be used to illustrate the Internal Revenue Service's approach to private benefit as the Supreme Court's approach to pornography. The conundrum that is private benefit has successfully withstood fifty years of efforts at explication. This outline will review those efforts.

II. Legal Context

A. Statutory and Regulatory Basis

Section 501(c)(3) provides for tax-exempt status for organizations “organized and operated exclusively for religious, charitable...” and other specified purposes. The statute itself does not mention “private benefit,” however, in 1959, Treas. Reg. § 1.501(c)(3)-1(c)(1) was promulgated setting forth a requirement that an organization will be regarded as “operated exclusively” for exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Treas. Reg. § 1.501-(c)(3)-1(d)(1)(ii) further provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public, rather than a private, interest. As a consequence, even if an organization has a number of activities that further public, that is, exempt, purposes, tax-exempt status may be precluded if a private interest is also served. This dire result was clearly enunciated in Better Business Bureau of Washington, D.C. Inc. v. United States, 326 U.S. 279 (1945), where the Court observed that the presence of private benefit, if substantial in nature, will destroy tax-exempt status regardless of an organization’s other charitable purposes or activities.

B. Inurement and Private Benefit

Closely related to the concept of private benefit is inurement, which is specifically prohibited by the statutory language of section 501(c)(3), in contrast to private benefit. From a practical perspective, inurement can be best understood as a subset of private benefit involving the inappropriate payment of money, or its equivalent, to an “insider,” someone in a position to exercise substantial influence over the affairs of the organization. Transactions that constitute inurement also trigger the excess benefit excise tax found in section 4958. In September 2005, Treasury and the IRS tried to clarify the substantive requirements for tax exemption under section 501(c)(3) by delineating the line between disqualifying private benefit and inurement by incorporating a series of examples into Treas. Reg. §1.501(c)(3)-1. The examples, however, were drawn from existing court decisions, thus adding little to the understanding of private benefit, but reinforcing its substantial negative impact.

C. Private Benefit Defined

In American Campaign Academy v. Commissioner, 92 TC 1053 (1989), the Court provided a useful definition of private benefit as non-incidental benefits conferred on disinterested persons that serve private interests.

1. “Incidental”

Clearly, organizations that provide an unquestionable public benefit, such as universities, also simultaneously convey a private

benefit on the students in the form of an education. Such “incidental” private benefit does not rise to the level of disqualifying an organization from tax exemption. In GCM 37789, IRS Chief Counsel’s Office noted that in order to avoid an adverse impact on tax-exempt status, any private benefit must be both qualitatively and quantitatively incidental. The IRS has expressed the view that a qualitatively incidental private benefit is one that is a “mere byproduct” of the public benefit being provided. See Topic H, *Private Benefit Under IRC 501(c)(3)*, EO CPE Text for FY 2001. The concept of private benefit as a byproduct of public benefit activities can be seen in Revenue Ruling 70-186, 1970-1 CB 128, concerning an organization formed to preserve and enhance a lake as a public recreational facility. The organization is financed by lakefront property owners, the public and municipalities bordering the lake. The revenue ruling concluded that the principal beneficiary of the organization’s efforts is the general public through improved recreational opportunities. The revenue ruling also recognizes that the lakefront property owners benefit as the value of their property is enhanced, however, it would be impossible for the organization to accomplish its purposes without providing the ancillary benefit to the property owners. The analysis set forth in Revenue Ruling 70-186, viewed by itself, seems clear. However, five years later, the IRS issued

Revenue Ruling 75-286, 1975-2 CB 210, where the public benefit provided by the organization in the revenue ruling was deemed to be outweighed by the private benefit inherent in civic beautification projects (planting trees and shrubs on public property in the neighborhood and picking up litter and refuse) confined to a single neighborhood. Membership in, and fundraising for, the organization were also restricted to the same neighborhood. A comparison of the facts in the 1970 revenue ruling and the 1975 revenue ruling demonstrates that the line between incidental and non-incidental benefit is difficult to discern. The geographic area that is the focus of the organizations' efforts is limited – a lake in the first case and a city block in the second. Both geographic areas are open to the public and the benefits from the organizations' efforts are not restricted in some overt way to property owners. Nevertheless, the IRS comes to opposite conclusions with regard to exempt status for the two organizations. The main, if unstated, difference seems to be a sense that beaches and boating have a broader, more beneficial, public impact than shady streets and sidewalks.

To be quantitatively incidental, the private benefit must be insubstantial in amount in comparison to the charitable or public benefit of the particular activity of the organization giving rise to the private benefit. The comparison is not to the public benefit

provided by the overall activities of the organization. For example, in an information memorandum dated May 11, 2007 and entitled “Hospitals Providing Financial Assistance to Staff Physicians Involving Electronic Health Records,” the IRS concludes that a financial subsidy to staff physicians limited by relevant regulations issued by the Department of Health and Human Services regarding electronic health records does not result in inappropriate private benefit. The relevant factor for assessing the amount of private benefit is the limit imposed by HHS rules, not the amount of public benefit provided by the hospital in question.

2. Benefits

While the memorandum on subsidies to doctors for electronic health records involved the transfer of money, private benefit does not necessarily involve the flow of funds, in contrast to inurement. In Revenue Ruling 76-206, 1976-1 C.B. 154, the IRS evaluated an organization formed to promote the broadcasting of classical music in a particular community. The organization carried on a variety of activities designed to stimulate public interest in the classical music programs of a for-profit radio station, thereby facilitating the station continuing to broadcast such music. The activities included soliciting sponsors, soliciting subscriptions to the station’s program guide and distributing pamphlets and bumper stickers encouraging people to listen to the station. The organization’s board of

directors represented the community at large and did not include any representatives of the for-profit station, thus precluding inurement based on “insider” benefit. The revenue ruling concludes that the organization’s activities enable the radio station to increase its total revenues and therefore benefit the for-profit station in more than an incidental way, resulting in an impermissible level of private benefit. A number of aspects of the revenue ruling bear mention: 1) there was no control by the for-profit station, 2) there was no direct flow of funds from the aspiring charity to the station, 3) the services provided by the aspiring charity are of the sort that the station would otherwise have had to purchase on its own, and 4) the aspiring charity’s overall purpose of promoting an interest in classical music provides a public benefit.

3. “Reasonableness of Payment” As A Defense

Unlike the concepts of inurement for purposes of section 501(c)(3) and excess benefit transactions under section 4958, a finding of impermissible private benefit does not require that payments for goods or services be unreasonable or exceed fair market value.

Such an approach was specifically rejected by the Tax Court in est of Hawaii v. Commissioner, 71 T.C. 1067 (1979). Similarly, in Church by Mail v. Commissioner, 765 F.2d 1387 (9th Cir. 1985),

aff'g TCM 1984-349 (1984), the 9th Circuit affirmed the Tax Court decision and described the requisite analysis as:

The critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the operation of the Church.

4. Disinterested Persons

Inurement solely involves benefit to “insiders” such as officers or directors. Private benefit, however, can involve benefits to anyone other than the intended recipient charitable class. Disinterested persons can include insiders, as well as related or unrelated third-parties, such as the for-profit radio station in Revenue Ruling 76-206, the business owned by the officers in Church by Mail, the travel agency in International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36 (1989) and the developers in Columbia Park & Recreation Association, Inc. v. Commissioner, 88 T.C. 1 (1987), aff'd 838 F.2d 465 (4th Cir. 1988).

5. Final Conundrum

In practice, determining whether disqualifying private benefit is present or not falls on the “facts and circumstances” of the specific

situation. Even IRS training materials admit that “in reality it is difficult to apply the private benefit analysis.” *Topic H – Private Benefit Under IRC 501(c)(3)*, Exempt Organizations Continuing Professional Education Training Text for FY 2001. The difficulty could not be better illustrated by Revenue Ruling 68-504, 1968-2 C.B. 211, in which an organization conducted training for bank employees in a given geographical area. Only members could enroll in courses taught by university professors hired by the organization, and membership was limited to bank employees in the area. In American Campaign Academy v. Commissioner, the Academy the educational nature of the training was not questioned and the classes were open to the public. The organization was, however, an outgrowth of a training program operated by the National Republican Congressional Committee and the record indicated that the graduates of the training program went on to work for Republican political candidates. The conundrum presented by the revenue ruling and the court case is that the bank training program qualified for tax-exempt status under section 501(c)(3) and the American Campaign Academy did not. Both factual situations involved incidental private benefit (the education received by the students) to a restricted group – in the bank case, by a *de jure* membership requirement limited to employees of banks in a particular geographic area and in the case of the

campaign academy, a *de facto* philosophical limitation to the Republican Party. Clearly, in both cases there is a secondary private benefit to an undetermined number of banks (by definition, for-profit) and a political party and its candidates/candidate committees (tax-exempt under section 527). The IRS distinguishes the cases thusly:

In the Academy's case, the true purpose of the admittedly educational activity was to benefit private interests (Republican candidates) by providing them with trained campaign workers. If the Academy had been truly non-partisan, it probably would have qualified for exemption. If the organization in Rev. Rul. 68-504 had provided training for employees of only one bank, it would not have qualified for exemption.

The difficulty with the IRS reasoning is two-fold: 1) the Court in American Campaign Academy affirmed the IRS denial of tax-exempt status on grounds of private benefit, not partisanship, and 2) although not restricted in a literal sense regarding where they sought employment, the campaign academy graduates went to work for many candidates/candidate committees and other political organizations united by a common political philosophy, but not necessarily any other link, a limitation that is actually more amorphous and imprecise than the geographic and employer-based

restrictions in the bank training example. Finally, it seems absurd to think that the private benefit that would accrue to a single non-charitable beneficiary (the Republican Party) could be cured by extending the private benefit to a larger, yet still limited, group, namely the banks in a particular geographic area. The conclusion appears inescapable that the true distinction between incidental and disqualifying private benefit is arbitrary, vague and ultimately indiscernible.

III. Specific Examples: Joint Ventures, Credit Counseling and Down Payment Assistance

Despite the clear difficulty in promulgating an analytic framework for private benefit, the IRS has moved forward in recent years with the application of the doctrine to deny tax-exempt status in at least three particular situations.

A. Joint Ventures

After considerable litigation and internal analysis, the IRS eventually came to the position that a charity can participate in a joint venture, whether a partnership, limited liability company or similar arrangement, as a charitable activity distinct from a business investment, without jeopardizing its tax-exempt status so long as the participation furthers the charity's exempt purposes and the terms of the arrangement do not prevent the charity from acting exclusively to further those purposes. See Plumstead Theatre Society, Inc. v. Commissioner, 74 T.C. 1324 (1980), aff'd 675 F.2d 244 (9th Cir. 1982). Developments involving whole-

hospital joint ventures clouded the analysis for a time. See Revenue Ruling 98-15, 1998-1 C.B. 718, Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999), aff'd 242 F.3d 904 (9th Cir. 2001), and St. David's Health Care System, Inc. v. United States, 349 F.3d 232 (5th Cir. 2003). In Revenue Ruling 2004-51, 2004-1 C.B. 974, the IRS seems to have signaled a return to the Plumstead analysis, albeit not without injecting some inconsistency into the rationale. Revenue Ruling 2004-51 sets forth a fact pattern involving a limited liability company, 50% of which is owned by a university and 50% by a for-profit company. The purpose of the LLC is to offer teacher training seminars at locations at off-campus locations via interactive video technology. The university's participation in the LLC constitutes an insubstantial part of its activities. The governing board of the LLC reflected the ownership interests; however, the university had the exclusive right to approve the curriculum and other educational aspects of the project. The for-profit had the exclusive right to select locations and non-teaching personnel involved in the delivery of the training. All contracts and transactions between the LLC, the university, the for-profit company and any other parties were at arm's length and fair market value. The revenue ruling concludes that the university is not subject to unrelated business income tax on its share of the income from the LLC on the grounds that the activity, given the university's control over the educational aspects of the training, constituted a "related" trade or business and that the tax-exempt status of

the university was not jeopardized. Clearly, the degree of control exercised by the university was determinative. As with much of the guidance on private benefit, however, Revenue Ruling 2004-51 is not completely consistent with prior positions. Recall that the IRS takes the position that private benefit is measured in the context of a particular activity, not the overall activities of the charitable organization. Assuming that is, indeed, still the IRS position, then it is irrelevant that the LLC activity in Revenue Ruling 2004-51 constitutes an insubstantial portion of the university's overall activity. The private benefit should be measured solely against the LLC activity, 50% of which confers a clear private benefit. Similarly, if an activity qualifies as a "related" activity, thus accomplishing a charitable purpose, then the extent of that activity should also be irrelevant; there is no exemption or exclusion for "insubstantial" unrelated business income in the Internal Revenue Code.

B. Credit Counseling

Spurred by media reports and the Senate Finance Committee, in 2002, the IRS began to aggressively review consumer credit counseling organizations recognized as exempt under section 501(c)(3). The IRS effort was hampered by a 1978 U.S. District Court decision in Consumer Credit Counseling Service of Alabama, Inc. v. United States, 78-2 USTC 9660 (D.D.C. 1978) which concluded that organizations providing credit counseling services did not have to limit services to low-income individuals to qualify for tax-exempt status and that debt management

programs were an “integral part” of credit counseling. As the examination effort progressed, the IRS began searching for a rationale to support revocation of tax exemption. Eventually, the Office of Chief Counsel issued CCA 200431023 (July 13, 2004) which set forth a number of possible arguments including that many credit counseling organizations might be engaged in impermissible private benefit through close relationships with for-profit service providers or through benefit to credit card issuing organizations who might benefit from the debt management activities of the counseling organizations. IRS Counsel recognized that the private benefit analysis involves a careful balancing of private and public benefit. In CCA 200620001 (May 9, 2006), IRS Counsel modified its position to one that appeared to find impermissible private benefit arising from debt management plans that did not meet the educational methodology standards of Revenue Procedure 86-43, 1986-2 C.B. 729, suggesting a view that credit card companies were receiving the private benefit. IRS Counsel’s theories have yet to be tested in the courts; however, because the Consumer Credit Counseling Service of Alabama found that debt management services were an “integral,” not “incidental,” part of credit counseling, it remains unclear how the government will fare.

C. Down Payment Assistance (“DPA”)

Another recent application of the private benefit doctrine to deny tax-exempt status under section 501(c)(3) is reflected in Revenue Ruling 2006-27, 2006-21 I.R.B. 1, which sets forth three examples of

organizations that provide assistance with down payments to individuals who are seeking to purchase a home. In the revenue ruling's example that results in a denial of tax-exempt status (two examples result in a favorable outcome), substantially all of the funds that the DPA organization provides to a purchaser comes from the seller of the home in question and the IRS characterizes the amounts as a rebate or purchase price reduction. The IRS concludes that the DPA organization is "structured and operated to assist private parties who are affiliated with its funders." Thus the relationship with the home seller is the source of the impermissible private benefit. Given that the provision of housing to appropriate target groups has long been seen as accomplishing a charitable purpose, and the housing invariably is acquired from an owner, the characterization of that transaction as a form of excessive private benefit when, in the IRS' own words the sales price of the home is reduced with a rebate, suggests that the only source of housing that will satisfy the IRS will be housing that is donated by owner or sold at some substantial reduction below fair market value – a result that does not seem supported by prior precedents involving housing organizations. E.g. Revenue Ruling 67-138, 1967-1 C.B. 129, Revenue Ruling 68-17, 1968-1 C.B. 247, and Revenue Procedure 96-32, 1996-1 C.B. 717.

IV. Practical Approaches to Addressing IRS Concerns

As the preceding discussion of private benefit suggests, there is a significant element of subjectivity in the way the IRS administers the rule. As a result,

there are no certain defenses to such an argument by the agency.

Nevertheless, there are some steps that can be taken to alleviate what is often a concern that a revenue agent or determination specialist may have difficulty articulating. Even though their actual impact on a private benefit argument may be oblique, the following steps seem to defuse IRS concerns generally:

- A board of directors that “reflects the community,” essentially a board that is not dominated by a particular family or business interest,
- Clear records reflecting the consistent achievement of charitable goals,
- A conflict of interest policy,
- A whistleblower policy,
- A commitment to ensuring that contracts and other financial transactions are at arm’s length and for fair market value (or less if to the benefit of the charity),
- An outside, independent auditor,
- If the organization is large enough, an internal auditor,
- Greater disclosure than is required by section 6033 (e.g. audited financial statements, stewardship report, etc.),
- Procedures and policies ensuring that the organization maintains an accountable plan for reimbursing employee business expenses,
- Achieving or striving to achieve the rebuttable presumption of reasonableness for compensation,
- A willingness to request a private letter ruling, if warranted by future developments.

While the preceding steps do not ensure that a private benefit argument will be successfully countered, and, in fact many address inurement or excess benefit transactions rather than private benefit, the IRS views them as hallmarks of good governance and thus derives comfort that the organization will achieve appropriate public purposes.