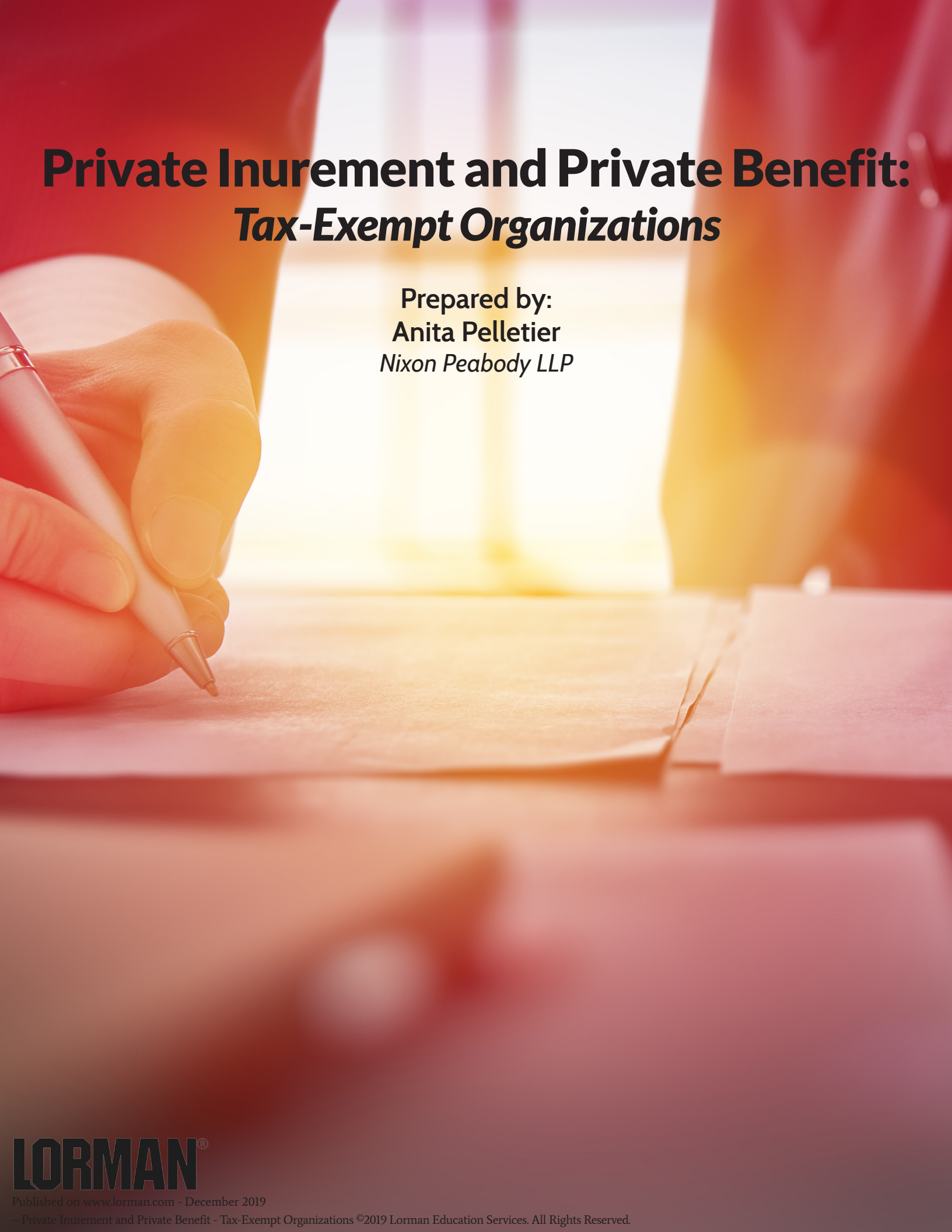

# Private Inurement and Private Benefit: *Tax-Exempt Organizations*


Prepared by:
Anita Pelletier
*Nixon Peabody LLP*


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# PRIVATE INUREMENT AND PRIVATE BENEFIT

Many types of organizations that are tax-exempt under Code Section 501(a) must be organized so that no part of the net earnings of the organization inure to the benefit of any private shareholder. Organizations that are tax-exempt under Code Section 501(c)(3) must also be organized and operated exclusively for charitable purposes, which can raise the issue regarding whether the organization operates for public, rather than private benefit.

## Private Inurement

Private inurement only applies to insiders and even a nominal amount is enough to result in the revocation of tax-exempt status. Inurement is any unjust earnings out of gross or net earnings and only applies to insiders who are individuals who stand in a relationship with the organization that gives the individual the opportunity to make use of the organization's income or assets for personal gain. *See Sound Health Association v. Commissioner*, 71 T.C. 158 (1978) appeal dism'd, (9th Cir. 1979), *acq.*, 1981-2 C.B. 2) (holding that to equate "insider" with potentially the whole community would so cut the insider test as to transmogrify it from a test to some precision in distinguishing private benefit to a test of such general application as to be useless.); *Cleveland Creative Arts Guild v. Commissioner*, T.C. Memo 1985-316 (finding no inurement because there was no private benefit conferred to persons having a personal and private interest in the activity of the organization).

As noted above, even a small amount of inurement is fatal. For example, in *Spokane Motorcycle Club v. U.S.*, 222 F. Supp. 151 (E.D. Wash. 1963), an organization that was tax-exempt under Code Section 501(c)(7) used net profits from its activities to pay for refreshments and meals for members during motorcycle tours. The court held that the prohibition against any net profits inuring to the benefit of private individuals was violated even though the amount was small—$825 (8% of gross revenues).

While the definition of an insider is narrow, it is not necessarily limited to directors, officers, or trustees. If conditions exist that give particular individuals significant influence over an organization's operations, those individuals may be treated as insiders in an economic sense. A common example is in the health care industry. For example, in General Counsel Memorandum ("G.C.M.") 39498 (1987), a hospital in desperate need of physicians used a very lucrative compensation plan to attract physicians. The IRS held that the hospital needed the physicians so badly that the physicians could dictate their own compensation agreements and enrich themselves at the hospital's expense. As a result, the physicians were considered economic insiders. Currently, physicians are generally considered insiders with respect to hospitals and other physician organizations and contracts, including compensation arrangements, need to be carefully considered and approved by the organization. *See*, Revenue Ruling 69-383, 1962-2 C.B. 113 (an exempt hospital that entered into a contract with a radiologist after arm's length negotiations that included payment of a percentage of the gross receipts of the radiology department did not jeopardize the hospital's tax-exempt status because the negotiations were at arm's length, the radiologist did not control the hospital, the amount received under the contract was reasonable in terms of the responsibilities and duties assumed by the radiologist, and the amount received under the contract was not excessive when compared to amounts received by other radiologists in comparable circumstances).

- *Rulings — Private Inurement*

*John Marshall Law School and John Marshall University v. United States*, 81-2 U.S. Tax Court 9514 (1981), the IRS revoked tax-exempt status based on violation of the private inurement prohibition. The court noted that the prohibition relating to "net earnings" does not prevent an organization from incurring ordinary and necessary expenses to support its operations. Therefore, the issue is whether the expenditures paid by the taxpayer on behalf of insiders were ordinary and necessary to its operations. Expenditures included multiple interest-free, unsecured loans used by the insiders to purchase and decorate a home; providing non-competitive scholarships to children of insiders; funding travel expenses that were not business related; and purchasing a health spa membership. Thus, the court upheld the revocation because insiders were "free to make personal use of such corporate funds for himself and his family when, and if, he chose to do so."

*Texas Trade School v. C.I.R.*, 30 T.C. 642 (5th Cir. 1959) in which the court held that inurement existed when a tax-exempt organization paid excessive rents to insiders and made valuable improvements to real estate owned by insiders.

*Lowry Hospital Association v. Commissioner*, 66 T.C. 850 (1976) in which the court held that inurement existed when a tax-exempt hospital made unsecured loans to a nursing home owned by the hospital's founder and a trust to benefit the founder's children as well as paying expenses of some of the nursing home residents.

*PLR 201507023*. IRS denied tax-exempt status to a booster club that supported youth sports, dance, tumbling, Tae Kwon Do, and other related activities. The primary activity disclosed in the exemption application was to fundraise to assist individuals enter competitions. While this seems like a pretty straight-forward 501(c)(3) activity, the organization further disclosed that funds raised by a family would be "earmarked for that family and go[es] toward[] their children's competition fees." The application further stated that families that did not fundraise were "responsible to pay for the portion of their children's competition and coaches fees." Following earlier precedent, the IRS ruled that this type of fundraising structure allowed the assets of the organization to inure to the benefit of insiders.

*PLR 201235021*. Organization developed an online donation management system including a mobile phone app. The organization contracted with a related for-profit entity to provide required hardware, software, and administrative services. The for-profit entity was owned by the three (3) members of the tax-exempt organization's board of directors. The for-profit entity was initially paid 20% of all donations collected through the donation management system, which was allegedly "well below" market rate. The tax-exempt organization later restructured to remove two of its three directors and restructured the contract to pay 8% to the for-profit entity. The IRS held that private inurement existed because the contract was not negotiated at arm's length, and there was no documentation that the fee paid was reasonable, especially because there was no cap. The IRS further held that removal of the two (2) directors was not sufficient to "cure" the conflict of interest that existed.

*PLR 201627002*. The IRS retroactively revoked an organization's tax exempt status based on private inurement because the organization regularly paid personal expenses for and on behalf of the founder (meals, cable, and vehicle expenses) without adequately documenting the expenses as salary or compensation because of private inurement or acts of private inurement benefiting its founder.

Private Benefit

The private benefit standard is derived from the requirements under Code Section 501(c)(3) that an organization must be organized and operated exclusively for charitable purposes as defined under Code Section 501(c)(3). Essentially, charitable organizations must be aware of operating for private rather than public benefit other than what is incidental to the organization carrying out its exempt purposes. Organizations should also note that private benefit can occur with individuals other than insiders and will not always result in jeopardizing an organization's tax-exempt status.

- *Organizational Test*

The organizational/primary purpose test provides that an organization is "organized exclusively for one or more exempt purposes only if its articles of organization … limit the purposes of such organization to one or more exempt purposes; and [d]o not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities that themselves are not in furtherance of one or more exempt purposes." Reg. Sections 1.501(c)(3)-1(a)(2)(b)(i). When determining whether an organization meets the organizational test, the IRS generally looks to the corporate documents of the organization rather than the specific activities. This test is generally satisfied by including specific language in the organization's certificate of incorporation.

- *Operational Test*

The operational test is focused on the activities of an organization. Regulations Section 1.501(c)(3)-(1)(c) states that

> [a]n 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 Code Section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities are not in furtherance of an exempt purpose.

Regulations Section 1.501(c)(3)-1(d)(1)(ii) further provides that an organization is not organized or operated exclusively for charitable purposes unless it serves a public rather than a private interest. It is also a settled principle of charity law that a charity's property is devoted to purposes which are considered beneficial to the community in general, rather than particular individuals. *See* IV A. Scott on Trusts, Sec. 348 (3d ed. 1967).

The leading case with respect to private benefit is *Better Business Bureau of Washington, D.C. v. U.S.*, 326 U.S. 279 (1945), which held that an organization formed for the mutual welfare and improvement of

business methods among business owners did not qualify as an educational organization because its activities were not exclusively educational. The court held 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." Here, the nonexempt purpose was promotion of business.

- *Incidental Private Benefit*

When reviewing activities to determine whether they serve public rather than private purposes, the issue is not whether private benefit exists, but rather whether the private benefit provided is "incidental" to the primary purpose of the activity. The word "incidental" in this context has both qualitative and quantitative meanings.

To be incidental in a qualitative sense, the benefit to the public cannot be achieved without necessarily benefiting certain private individuals. In other words, the private benefit is a mere byproduct of the public benefit. G.C.M. 37789. Determining if a private benefit is incidental involves a fact-specific analysis. To satisfy the qualitative requirement, the organization must demonstrate that the benefit to the public cannot be achieved without also benefitting some private individuals. In Revenue Ruling 70-186, 1970-1 C.B., community members formed an organization to preserve a lake as a recreational facility and to improve the condition of the lake to enhance its recreational features. The purposes served by the organization would benefit the public at large, but would also inevitably and significantly benefit the individuals who owned property on the lake. However, the IRS determined that the private benefit to the property owners was incidental and it would be impossible for the organization to achieve its goal of improving the lake without conferring some private benefit.

As for the quantitative requirement, the private benefit must be insubstantial in amount when compared to the public benefit of the specific activity, not the public benefit derived from all of the organization's activities. The more an organization can quantify exactly the private benefit, the more likely it will be considered not to be incidental. Conducting activities with a single entity/individual or group of related entities/individuals will also generally indicate impermissible private benefit. See, Rev. Rul. 76-152, 1976-1 C.B. 151 (holding that an organization formed to promote modern arts in the community by displaying and selling works of local artists in its gallery (gallery kept 10% of the sale with 90% paid to the artist) was operated for private benefit that was not incidental because the sale of artwork provided the artist with a direct monetary benefit that enhanced that artist's career); *Senior Citizens of Missouri, Inc. v. C.I.R.*, T.C. Memo 1988-493 (1988) (organization denied tax-exempt status because it did not conduct a program of charitable activities commensurate with its resources and was operated for impermissible private benefit because it paid employees compensation that was not documented as being reasonable).

- *Rulings — Private Benefit*

*PLR 201626025*. The IRS revoked the tax-exempt status of a motorcycle club following an IRS examination because the club "provides more than insignificant private benefit to members and affiliated individuals" because its activities were primarily social and recreational.

*PLR 201632020*. IRS denied tax-exempt status for an organization formed to create a support system for members of an immigrant community by providing funds to members or their registered family

members who have lost a family member to assist with funeral expenses. The organization submitted that it lessened the burdens of government and provides relief to the poor and underprivileged because many individuals in the immigrant community have little to no information regarding life insurance or saving money.

*PLR 201637017*. The IRS denied tax-exempt status to an organization formed by a couple to "assist adolescent children and families coping with undiagnosed and/or debilitating diseases." The organization was named after the founders' son and fundraising materials specifically referenced the founders' son. The IRS noted that since its formation, the only individual to receive funds from the organization was the founders' son and less than 4% had been given to other charitable organizations. Denial was based on both private benefit and private inurement concerns.

*PLR 201710031*. The IRS revoked tax-exempt status of an organization that provided college scholarships to high school students because its primary activity was rental of its facilities, which was an unrelated business activity. The IRS noted that conducting an unrelated trade or business will not generally jeopardize exempt status unless it "rises to the level of questioning whether the organization is operated *primarily* for commercial or exempt purposes." Specifically, the organization's unrelated business activity was more than an insubstantial part of its activities, which means the organization was not operated exclusively for exempt purposes.