C. OVERVIEW OF INUREMENT/PRIVATE BENEFIT ISSUES IN IRC 501(c)(3)

1. Preface

An apocryphal domestic relations case has a judge inquiring of the elderly plaintiff about why, after some fifty years of marriage, she was now seeking a divorce. "Well, your honor," she replied, "enough is enough!"

In the charitable area, some private benefit may be unavoidable. The trick is to know when enough is enough.

2. Introduction

IRC 501(c)(3) provides exemption from federal income tax for organizations that are "organized and operated exclusively" for religious, educational, or charitable purposes. The exemption is further conditioned on the organization being one "no part of the net income of which inures to the benefit of any private shareholder or individual." This article examines the proscription against inurement and the requirement that an organization must be organized and operated exclusively for exempt purposes by serving public rather than private interests.

3. The Prohibition Against Inurement of Net Earnings

A. What Is Inurement?

The statutory prohibition against inurement of net earnings first appeared in 1894. The provision has been carried forward without significant Congressional comment or debate through successive revenue acts and codifications. See "The Concept of Charity" in the Exempt Organizations Annual Technical Review Institutes for 1980 beginning at page 7. While the provision speaks of "net earnings," it is not interpreted in a strict accounting sense to mean the remainder after expenses are subtracted from gross earnings. Any unjust enrichment, whether out of gross or net earnings, may constitute inurement. See People of God Community v. Commissioner, 75 T.C. 127 (1980).

Regs. 1.501(c)(3)-1(c)(2) explains the prohibition against private inurement as follows:

> Distribution of earnings. 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 individuals. For the definition of the words "private shareholder or individual," see paragraph (c) of section 1.501(a)-1.

Regs. 1.501(a)-1(c) states that "[t]he words 'private shareholder or individual' in section 501 refer to persons having a personal and private interest in the activities of the organization."

The regulations are silent concerning the meaning of "inures" because neither the courts nor the Service have found it necessary to place any special meaning on the term. Whether an impermissible benefit has been conferred on someone is treated essentially as a question of fact. Rather, the Service and the courts have focused on the meaning of the term "private."

The word "private" has been held to mean the antonym of "public"--used to distinguish a private individual from the general public--and is intended to limit the scope of those persons who personally profit from an organization to the intended beneficiaries of the allowable activities. See Kemper Military School v. Crutchley, 274 F. 125, 127 (W.D. Mo. 1921). Thus, the capacity in which an individual derives financial benefit will determine whether prohibited inurement exists.

The distinction between an individual as a private person and the individual as a member of the general public incorporates the following two concepts which are basic to unraveling inurement problems: (1) An individual is not entitled to unjustly enrich himself at the organization's expense. (2) Benefits directed to an individual as a member of a charitable class do not constitute unjust enrichment.

The second proposition has created fewer problems than the first. A member of an exempt hospital's governing body can be admitted to the hospital on the same basis as any other member of the community. A donor to the public library can check books out of the library. A church officer can attend functions held or sponsored by the church. But, problems do arise when an individual's receipt of a benefit is founded on economic as well as charitable considerations.

In Wendy L. Parker Rehabilitation Foundation, Inc. v. C.I.R., T.C. Memo. 1986-348, the Tax Court upheld the Service's position that a foundation formed to aid coma victims, including a family member of the founders, was not entitled to

recognition of exemption. Approximately 30% of the organization's net income was expected to be distributed to aid the family coma victim. The Court found that the family coma victim was a substantial beneficiary of the foundation's funds. It also noted that such distributions relieved the family of the economic burden of providing medical and rehabilitation care for their family member and, therefore, constituted inurement to the benefit of private individuals.

1. Inurement Comes in Different Forms

Individuals are not the only entities that have economic interests. Exempt organizations have economic interests of their own. They must acquire assets and equipment, hire employees, and purchase professional services in order to conduct their activities. There is no prohibition against an exempt charity dealing with its founders, members, or officers in seeing to the conduct of its economic affairs. However, any transaction between an organization and a private individual in which the individual appears to receive a disproportionate share of the benefits of the exchange relative to the charity served presents an inurement issue. Such transactions may include assignments of income, compensation arrangements, sales or exchanges of property, commissions, rental arrangements, gifts with retained interests, and contracts to provide goods or services to the organization.

> [Private foundations described in IRC 509(a), including nonexempt charitable trusts described in IRC 4947(a)(1), are subject to additional restrictions on acts of self-dealing under IRC 4941 with respect to disqualified persons. See sections (13)40 through (13)42 of IRM 7752. Also, see Section 7 of this article.]

Modern compensation arrangements include a variety of benefits in addition to salary. See the article on Reasonable Compensation in this CPE course book. The general rule is that if the arrangements are indistinguishable from ordinary prudent business practices in comparable circumstances, a fair exchange of benefits is presumed and inurement will not be found. If the transactions depart from that standard to the benefit of an individual, a finding of inurement should be made.

2. Examples Involving Compensation

Rul. 69-383, 1969-2 C.B. 113, is an example of a possible inurement situation which did not jeopardize an organization's exempt status. In the revenue ruling a tax exempt hospital entered into a contract with a radiologist after arm's-length negotiations. The contract provided for the radiologist to be compensated by

receiving a percentage of the gross receipts of the radiology department. The revenue ruling concluded that the agreement did not jeopardize the hospital's exempt status under IRC 501(c)(3). In support of this conclusion, the following facts were noted: the agreement was negotiated on an arm's-length basis, the radiologist did not control the hospital, the amount received under the contract was reasonable in terms of the responsibilities and duties assumed, and the amount received under the contract was not excessive when compared to the amounts received by other radiologists in comparable circumstances.

A case illustration of a typical attempt to characterize inurement as reasonable compensation is John Marshall Law School and John Marshall University v. United States, 81-2 USTC 9514 (Ct. Cl. 1981). In that case a private, unaccredited, law school and college were operated by two brothers, Theo and Martin Fenster, and members of their families. The Service revoked the exemption of both organizations on the ground that part of the net earnings of the organizations inured to the benefit of private shareholders or individuals. The organizations filed a declaratory judgment action in the Court of Claims. The Court opened its discussion of the case by noting that

> [t]he term "net earnings"...has been construed to permit an organization to incur ordinary and necessary expenses in the course of its operations without losing its tax-exempt status....The issue, therefore, is whether or not the expenditures JMLS paid to or on behalf of the Fenster family were ordinary and necessary to JMLS operations. Supra, at 87,685.

The Court detailed with particularity each of a series of interest-free, unsecured loans used by the Fensters to purchase a home and furnish it, the granting of noncompetitive scholarships to the Fenster children, and payment of nonbusiness related expenses for travel, health spa membership and entertainment. Although one of the loans was evidenced by a promissory note, the note made no provision for a definite repayment schedule. In response to the argument that one of the scholarships was merely the equivalent of a death benefit (Martin Fenster had been murdered three months earlier), the Court acknowledged that a death benefit was authorized under the tax Code but stated that the section had nothing to do with authorizing inurement of earnings of the organization to an individual. The Service's revocation of the organizations' exemptions was upheld.

3. Other Examples

Other case examples of inurement include payment of excessive rent, Texas Trade School v. Commissioner, 30 T.C. 642, aff'd. 272 F.2d 168 (5th Cir. 1959); receipt of less than fair market value in sales or exchanges of property, Sonora Community Hospital v. Commissioner, 46 T.C. 519 (1966); and inadequately secured loans, Lowry Hospital Association v. Commissioner, 66 T.C. 850 (1976).

Attempting after the fact to demonstrate that an undocumented transaction is a typical business arrangement is not likely to prevent a finding of inurement. In Founding Church of Scientology v. United States, 412 F.2d 1197 (Ct. Cl. 1969), cert. den., 397 U.S. 1009 (1970), an organization argued that it had paid its founder for expenses incurred in connection with his services, made reimbursements to him for expenditures on its behalf, and made some payments to him as repayments on a loan. The organization could produce no evidence of contractual agreements for services, documents evidencing indebtedness, or any explanation regarding the purposes for which expenses had been incurred. The Court concluded that—

> nothing we have found in the record dispels the substantial doubts the court entertains concerning the receipt of benefit by the Hubbards from plaintiff's net earnings. Since plaintiff has failed to meet its burden of proof, we hold therefore that a part of the corporate net earnings was a source of benefit to private individuals. Supra, at 1202.

But see Alive Fellowship of Harmonious Living v. Commissioner, T.C. Memo. 1984-87, holding that no inurement resulted when an organization's members received benefits on the basis of need. However, in approving this "unconventional" compensation arrangement, the Court based its decision on members receiving less than modest assistance which did not exceed the value of the required services performed.

B. Insiders

A common factual thread running through the cases where inurement has been found is that the individual stands in a relationship with the organization which offers him the opportunity to make use of the organization's income or assets for personal gain. This has led to the conclusion that a finding of inurement is usually limited to a transaction involving insiders. In People of God Community v. Commissioner, supra, the Court had to decide whether a percentage compensation arrangement for an organization's minister resulted in unreasonable compensation. The Court noted that there was no upper limit on the amount of compensation the minister could receive. Because there was no upper limit, the

Court found that a portion of the church's earnings was simply being passed on to its minister. The Court noted that the prohibition against inurement and the prohibition against benefit to private interests do overlap and took pains to make clear that it was basing its decision on inurement:

> What is prohibited is inurement 'to the benefit of any private shareholder or individual.' Section 501(c)(3); section 1.501(c)(3)-1(c)(2), Income Tax Regs. The term 'private shareholder or individual' refers to persons who have a personal and private interest in the payor organization. Section 1.501(a)-1(c), Income Tax Regs.; Gemological Institute of America v. Commissioner, supra. The term does not refer to unrelated third parties. Supra, at 133.

Additional Tax Court opinions holding that inurement is confined to insiders include Sound Health Association v. Commissioner, 71 T.C. 158 (1978), appeal dism'd, (9th Cir. 1979), acq., 1981-2 C.B. 2. Alive Fellowship of Harmonious Living, cited above, and Cleveland Creative Arts Guild v. Commissioner, T.C. Memo. 1985-316. However, mere concentration of power in one or a few persons or groups does not justify disqualification on account of inurement. See Unitary mission Church of Long Island v. Commissioner, 74 T.C. 531 (1980), aff'd, 670 F.2d 104 (9th Cir. 1981). Similarly, a climate for abuse created by such control or dominance does not justify disqualification. See The Church of the Visible Intelligence that Governs the Universe v. U.S., 4 Cl. Ct. 55 (1985). Control becomes relevant when it is abused.

In St. Germain Foundation v. Commissioner, 26 T.C. 648 (1956), the control issue was placed in proper perspective. There the Court observed:

> It is true, as respondent indicates that...two of the three members of the board of directors, were in control of the activities of the petitioner both in matters of religious instruction and in financial matters. We do not see the significance of this, however, where such control, by the majority of the board of directors, is exercised to carry out the avowed religious purposes of the petitioner and where such control is not employed, so far as the evidence and the record as a whole reveal, to channel net earnings of the petitioner to private shareholders or individuals. Supra, at 660.

Nevertheless, the presence of control of an organization by a few insiders should lead to close scrutiny for the presence of situations overly beneficial to such insiders.

C. Who Is an Insider?

The limits delineating exactly what status an individual has to occupy in relation to an organization in order to be treated as an insider are still being tested. G.C.M. 39498 (January 28, 1986) provided an indication of the Service's thinking on that question in commenting on an exempt hospital's physician recruitment program.

Under the program the hospital paid recruited physicians a guaranteed minimum annual income for two years with no obligation to repay the subsidies out of income earned after the contract period. The subsidies were based on factors related to a physician's earnings in his or her private medical practice. G.C.M. 39498 agreed that the hospital was required by market forces to offer some incentives to attract qualified physiciansneeded to enable the hospital to provide quality health care. But, that fact did not establish that the recruitment program would not jeopardize the hospital's exempt status.

> We view the question of subsidies under the hospital's physician recruitment program to be essentially a question of whether a given compensation arrangement comports with the requirements of exemption. Such subsidies or the method of determining the amount of subsidies may result in inurement of the hospital's net earnings to the physicians recruited to the staff of the hospital, or demonstrate that private interest are being served.
>
> In our opinion, the recruited physicians as employees or as individuals with a close professional working relationship with the hospital are persons who have a personal and private interest in the activities of the hospital. Thus, such physicians are subject to the inurement proscription. Supra, at 4.

The viewpoint expressed indicates that the Service does not intend to limit the class of insiders to persons who are able to exercise legal control over the organization as officers, directors, or trustees. If market conditions are such as to give particular individuals significant influence over the organization's operations, they may be treated as insiders in an economic sense. Since hospitals were in stiff

competition for a limited number of physicians in certain specialties, the physicians could effectively dictate their own compensationarrangements and enrich themselves at the hospital's expense. G.C.M. 39498 questions the reasonableness of the compensation arrangement since it is not based on services rendered directly to the hospital but, rather, on a physician's private medical practice; factors which are extrinsic to performance at and benefit to the hospital.

G.C.M. 39498 does not stand for the proposition that all dealings with individuals who hold an economic bargaining advantage will automatically result in a finding of inurement. In Rev. Rul. 73-313, 1973-2 C.B. 174, an organization was formed and supported by residents of an isolated rural community to provide a medical building and facilities at a reasonable rent to attract a doctor who would provide medical services to the community. The organization was held to be promoting the health of the community as a whole and was therefore exempt under IRC 501(c)(3).

The distinction between G.C.M. 39498 and Rev. Rul. 73-313 is where the transactions fall on a scale of being reasonably related to services that further exempt purposes. Rev. Rul. 73-313 noted that "[t]he terms of the arrangement entered into to induce the doctor to locate his practice in the locality bear a reasonable relationship to promotion and protection of the health of the community." Accordingly, there was a direct relationship between the benefit provided to the physician (an affordable medical facility) and the charity served (community access to medical care) which factor was absent in G.C.M. 39498.

Chief Counsel's position that the class of insiders includes employees has not been affirmed by the courts. In Senior Citizens of Missouri, Inc. v. Commissioner, T.C. Memo. 88-493, an organization raised funds through telephone solicitation. It paid each of the solicitors a 25% commission. In addition the organization made advances against commissions to some solicitors. In 1985 the advances amounted to 33.2% of gross income. Therefore, commissions and advances together were equal to 58.2% of the organization's gross receipts. The organization paid 8.9% of its gross receipts for the direct conduct of activities in furtherance of its exempt purpose.

The Service denied the organization's application for recognition of exemption on two grounds; that it did not conduct a program of charitable activities commensurate with its resources and that its expenditures for commissions and advances constituted inurement. The organization, represented

only by one of its officers who was not knowledgeable in tax affairs, filed for declaratory judgment in the Tax Court.

The Court reviewed the administrative record and noted that the Service had focused on the advances, not the commissions, in reaching its adverse decision. So far as the record revealed, none of the advances had ever been repaid even though they were supposed to have been offset against commissions. Citing IRC 162, the Court noted that compensation must not only be reasonable in amount, it must be incurred for services performed. Since the organization had not come forward with any evidence of how the amount of each advance was determined, it had failed to establish any connection between advances paid and services actually rendered. The Court concluded that, so far as the record was concerned, the advances were simply a private benefit conferred on the solicitors by the organization. Since the advances accounted for a third of the organization's gross receipts, the private benefit was substantial by any measure. Therefore, the organization was not operated exclusively for exempt purposes. The Service's denial of the organization's exemption was sustained, but using a private benefit analysis rather than inurement.

[But, also see World Family Corporation v. Commissioner, 81 T.C. 958 (1983), in which the Court found that a contingent fee fund raising program whereby solicitors, including officers of the organization, received a twenty percent commission based on the amount raised represented reasonable compensation. The Court noted that a commission which may be reasonable when paid to an unrelated third party is not per se unreasonable when paid to an interested individual having a personal and private interest in the payor organization. The Court found that commissions were payable to any individual who procured funds under terms comparable to the cost for outside services in an arm's-length transaction. It appears that the record was not sufficiently developed to demonstrate whether in fact (1) the commissions were paid to persons in control who may not have performed services related to contributions solicitation and, (2) there was any ceiling on the commissions. Other courts have found that a percentage compensation arrangement precludes an organization's exemption under IRC 501(c)(3) where such arrangement is merely a device for distributing profits to persons in control. See Birmingham Business College, Inc. v. Commissioner, infra; Gemological Institute of America v. Commissioner, 17 T.C. 1604 (1952), aff'd per curiam, 213 F.2d 205 (9th Cir. 1954); and People of God Community v. Commissioner, supra.]

D. A Little Inurement Goes a Long Way

Even a small amount of private inurement is fatal to exemption. In Spokane Motorcycle Club v. U.S., 222 F. Supp. 151 (E.D. Wash. 1963), net profits were found to inure to private individuals where refreshments, goods and services amounting to $825 (representing some 8% of gross revenues) were furnished to members. See also Founding Church of Scientology of Washington, D.C., cited above.

If inurement can result from an insider receiving a little benefit, it follows that inurement must result when the insider receives virtually all of the benefits of the organization's operations.

Where the property and income of a religious community was held for the common use and benefit of its members to be used for their support and maintenance (and the support and maintenance of the heirs of deceased members), the Court of Claims found that there was inurement of net earnings to the benefit of private shareholders or individuals. Hoffer v. U.S., 64 Cl. Ct. 672 (1928). (But, see IRC 501(d) which provides taxexemption for certain religious or apostolic organizations. See also Beth-El Ministries, Inc. V. U.S., 79-2 USTC 9412 (D.C. D.C. 1979), where exemption was denied because the organization failed to meet its burden to show that no part of its net earnings inured to the benefit of any of its members who were entitled to receive benefits in the form of food, clothing, shelter, medical care, recreational facilities, and educational services in exchange for a commitment by donating all possessions and salaries to the organization.)

4. Serving a Public Rather than a Private Interest

In Hoffer, cited above, and in a related case, Hutterische Bruder Gemeinde v. Commissioner, 1 B.T.A. 1208 (1925), there was also a finding that such corporations were not operated exclusively for religious purposes because they operated for the benefit of their members. The Court in Alive Fellowship of Harmonious Living, cited above, stated that the requirement that an exempt organization be operated for public rather than private benefit is but another way of requiring that it be operated exclusively for exempt purposes; it is a factual issue. Although the requirements for finding inurement or private benefit are similar, inurement and private benefit differ in that inurement has generally been applied only to insiders with some authority with respect to an organization, whereas private benefit may accrue to an independent outsider. Moreover, even a minimal amount of inurement can result in disqualification for exempt status, whereas private benefit must be substantial in order to jeopardize exempt status. However,

even substantial private benefit may be tolerated where it is incidental to the accomplishment of charitable purposes.

Regs. 1.501(c)(3)-1(d)(1)(ii) states that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. The regulation places the burden of proof on the organization to demonstrate 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 statement that an organization must serve a public rather than a private purpose is a basic tenet of the law of charity. It can be applied in place of or in addition to the proscription against private inurement. The application of the principle is illustrated by two assignment of income revenue rulings.

Rev. Rul. 78-232, 1978-1 C.B. 69, describes the ABC Church, whose membership consisted of an individual, the individual's spouse, their two minor children, and a few family friends. The individual was employed by a state government and deposited his salary checks in the Church's bank account. The Church's account was primarily used to furnish the individual and his family with lodging, food, clothing, and other living expenses. The individual was denied a deduction under IRC 170 for the salary checks deposited in the Church's account because the Church was operated for the private purposes of the individual and its income inured to the individual and members of his family.

In Rev. Rul. 81-94, 1981-1 C.B. 330, a nonprofit organization was formed by a professional nurse. The organization described itself as a church. The nurse functioned as the church's minister, director, and principal officer and "donated" the money from his/her outside employment to the church. The only function the church performed was acting as a vehicle for handling the nurse's personal finances. The revenue ruling holds that the church was not exempt because it served the private interests of a designated individual rather than the public interest.

A. Primary Purpose and Substantial Nonexempt Purpose

The amount of private benefit that will be permitted depends on the magnitude of the private benefit in relation to the public benefit derived from the organization's activities and whether the private benefit is necessary in order to effectuate the organization's exempt purpose.

The private benefit standards do not derive from that portion of the statute which prohibits inurement of net earnings. They are based on that portion of IRC 501(c)(3) that requires an organization to be "operated exclusively" for exempt purposes. However, "operated exclusively" has two meanings. Both meanings are contained in Regs. 1.501(c)(3)-1(c)(1):

> (c) Operational test. (1) Primary Activities. 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.

The "primary activities" portion of the regulation helps to harmonize the regulation with the unrelated business income tax provisions set forth in Regs. 1.501(c)(3)-1(e)(1) which allow an exempt organization to engage in unrelated trade or business activity so long as engaging in such trade or business is not the organization's primary purpose. The not "more than an insubstantial part of its activities" standard can be understood by reference to Better Business Bureau v. U.S., 326 U.S. 279 (1945), which held that an organization which engaged in some educational activity but pursued nonprofit goals outside the scope of the statute was not exempt under IRC 501(c)(3). The Court stated that an organization is not operated exclusively for charitable purposes if it has a single noncharitable purpose that is substantial in nature. This is true regardless of the number or importance of the organization's charitable purposes. Thus, the operational test standard prohibiting a substantial nonexempt purpose is broad enough to include inurement, private benefit, and operations which further nonprofit goals outside the scope of IRC 501(c)(3).

B. The Primary Purpose Test

The Code speaks of purposes while the operational test focuses on activities. But purposes may be inferred from activities.

The courts recognize that a single activity can serve both an exempt and a nonexempt purpose. In such cases the problem is determining the organization's primary purpose. The outcome depends on the weight assigned to various indicators of exempt versus nonexempt purpose. For a discussion of cases applying

the primary purpose test to distinguish commercial from religious publishing, see the article in the 1988 CPE beginning at page 62.

Application of the primary purpose standard involves a weighing of facts and circumstances which vary greatly from case to case. This gives the Service and the courts considerable discretion in rationalizing a decision in a particular case. It also limits the precedential value of a case or revenue ruling because it is almost always possible to factually distinguish a given case from those that have come before the courts or the Service.

The Service's ability to successfully persuade a court to adopt its position in a particular case depends on a detailed knowledge of all of the facts and circumstances surrounding the organization's operations. If the facts show a consistent pattern of nonexempt purpose based on activity, the court will uphold the Service's determination that the organization is not exempt. However, obtaining the information necessary to demonstrate such a pattern is not always easy.

A case in point is Church of Scientology of California v. Commissioner, 83 T.C. 25. 381. The Service recognized the Church as an organization exempt from federal income tax under IRC 501(c)(3) in 1957. In 1967 the Service revoked the Church's exempt status. In 1975 the Service began an examination of the Church for its taxable years 1971 through 1974. Three experienced agents worked full time on the audit assisted by junior agents as needed for a period of one year. They examined between 200 and 300 cartons of documents containing approximately 2 million documents. Because the organization did not keep books and records conforming to generally accepted accounting principles it had no ledgers or journals. Original invoices and documents had to be used in establishing the nature of its financial affairs. The boxes of documents were sometimes mislabeled and the records within each box were not in chronological order. The checks were detached from their stubs. It took three or four examiners from one to two weeks simply to organize 49 boxes.

The Church gave misleading explanations of its dealings with Overseas Transport Corporation, a sham corporation used to funnel Church funds to L. Ron Hubbard, the Church's founder. The Church also misled the Service regarding the existence of substantial income from its operations in the United Kingdom, representing that they were conducted by a corporate entity separate from the Church.

In spite of the Church's deliberate efforts to impede, delay, and frustrate the examination, the Service was able to piece together a general overview of its operations sufficient to convince the Tax Court that evidence of the Church's commercial purpose existed "practically everywhere we turn." The evidence cited by the court, assembled during 51 days of testimony and arguments, was that the organization sold its religious services through a subordinate system of franchisees, that it paid commissions on the sales of religious goods and services, that it amassed sizable annual profits, and that it maintained substantial unexplained cash reserves. At one point in 1972 slightly over $3 million in cash was stored in a safe to which only the founder and his wife had access.

In addition to having exclusive control of these large sums of cash, the founder and his family received a variety of benefits from the Church including residence aboard a ship and payment of all their living and medical expenses. They received royalties on sales of books and patented devices created by the founder (and the Church in some instances) and sold through the Church. The Church aggressively marketed all these items and allowed itself to be used to collect alleged "debt repayments" to the founder from the subordinate churches generally amounting to 10% of each subordinate church's gross receipts. The Court found this method of operation to be similar to a commercial franchise operation.

The Tax Court sustained the Service's revocation of the Church's exempt status on three grounds:

> (1) Inurement of the Church's income to its founder through payments to dummy trusts and corporations controlled by the founder. Some of the payments were supported by false billing invoices manufactured by Church personnel.
>
> (2) A commercial purpose, shown by an overriding and obsessive interest in maximizing profits from sales of Scientology related goods and services, documented by written directives from the Church to its subordinates exhorting them to "MAKE MONEY. MAKE MONEY. MAKE MORE MONEY."
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> (3) Violations of public policy, including successful efforts by Church personnel to conceal from the Service the Church's extensive overseas operations and thus avoid the assessment and collection of taxes which were lawfully due.

The Tax Court's decision was affirmed by the appellate court which based its decision solely on the inurement ground of the Tax Court opinion. Church of Scientology of California v. Commissioner, 823 F.2d 1390 (9th Cir. 1987), cert. denied, 107 S. Ct. 1752 (1988). The case occupied the attention of the Service, the Justice Department, and the courts for a period of over 10 years.

C. Incidental Private Benefit

Two early cases, previously mentioned, which laid part of the groundwork for the analysis of private benefit involved communal religious organizations which engaged in large scale commercial farming operations and supported their members out of the proceeds of the farming operation. See Hutterische Bruder Gemeinde v. Commissioner and Hoffer v. United States, cited above. The eventual result was the enactment of IRC 501(d), which disposed of the problem by granting exemption to the organization while requiring the individual members to assume income tax liability for their pro rata shares of the proceeds of the communal business enterprise. However, the superior benefits of recognition under IRC 501(c)(3) continue to attract organizations which are more or less similar in nature to those described in IRC 501(d).

This problem of a communal religious organization was again considered by Chief Counsel in G.C.M. 38827 (December 7, 1981).

The facts in G.C.M. 38827 were that members of an applicant organization lived, worked, and worshipped together in a tight knit community in a wilderness area. They engaged in logging, farming, fishing, and similar activities to the degree necessary for the community to subsist. However, the community operated no business enterprise of its own. Chief Counsel concluded that the lack of a communal business enterprise prevented the organization from qualifying for exemption under IRC 501(d). Chief Counsel further concluded that since the organization lacked a communal business enterprise, there was nothing inherent in its structure or operations which would bar exemption under IRC 501(c)(3).

Chief Counsel noted that while objections had been stated in three terms--substantial nonexempt purpose, inurement, and benefit to private interests--the underlying objection to exemption of the organization was that its activities were oriented to its own membership rather than to the general public. Chief Counsel noted that a similar problem had recently been addressed in G.C.M. 38459 (July 31, 1980). In G.C.M. 38459, Chief Counsel had observed that "an organization which serves a private interest other than incidentally is not entitled to exemption

as an organization described in section 501(c)(3). Thus, although an organization's operations serve a public interest, exemption will be denied if private interests are also served." In G.C.M. 38459 Chief Counsel reaffirmed the standards previ ously set forth in G.C.M. 37789 (December 18, 1978) for determining whether private benefit is more than incidental. The discussion in G.C.M. 37789 on this point is set forth below.

> ...[I]f an organization serves a public interest and also serves a private interest other than incidentally, it is not entitled to exemption under section 501(c)(3)...This proposition is simply an expression of the basic principle underlying the enforcement of charitable trusts and their exemption from federal income taxation under section 501(c)(3): Their property is devoted to purposes which are considered beneficial to the community in general, rather than particular individuals. See, e.g., IV A. Scott on Trusts, section 348 (3d ed. 1967). Thus, although an organization's operations may be deemed to be beneficial to the public,...if it also serves private interests other than incidentally, it is not entitled to exemption.

1. Qualitative and Quantitative

In our opinion, the word "incidental" in this context has both qualitative and quantitative connotations. We think it is qualitative in the sense that to be "incidental", the private benefit must be a necessary concomitant of the activity which benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefiting certain private individuals. An example of this qualitative aspect is provided by Rev. Rul. 70-186, 1970-1 C.B. 128. In that ruling, an organization was formed to preserve a lake as a public recreational facility and to improve the condition of the water in the lake to enhance its recreational features. Although the organization clearly benefited the public at large, there necessarily was also significant benefit to the private individuals who owned lake front property. The Service determined, however, that the private benefit was incidental in a qualitative sense, stating:

> > The benefits to be derived from the organization's activities flow principally to the general public through the maintenance and improvement of public recreational facilities. Any private benefits derived by the lake front property owners do not lessen the public benefits flowing from the organization's operations. In fact, it would be impossible for the organization to accomplish its purposes without providing benefits to the lake front property owners. [Emphasis added.] Supra, at pages 6 and 7.

There is also a quantitative connotation to the term "incidental" in this context. In Rev. Rul. 76-152, 1976-1 C.B. 151, a group of art patrons formed an organization to promote community understanding of modern art trends. The organization

selected modern art works of local artists for exhibit at its gallery, which was open to the public, and for possible sale. If an art work was sold, the gallery retained a commission of ten percent and paid the remainder to the artist. In our consideration of the proposed revenue ruling in G.C.M. 35701...we stated that:

> If the purposes or operations of an organization are such that private individuals who are not members of a charitable class receive other than an insubstantial or indirect economic benefit therefrom, such activities are deemed repugnant to the idea of an exclusively public charitable purpose. ..This result is the same, moreover, even if the purposes and activities of the organization would be charitable were it not for the element of private benefit.
>
> On the facts of the instant proposal we believe a prohibited direct economic benefit is conferred on the individual artists by the gallery's sale and rental of the art works. ....[T]he sale activity provides the artist with a direct monetary benefit and serves to enhance his artistic career. This benefit cannot be dismissed as being merely incidental to the organization's other exempt purposes and activities as it is substantial by any measure.

It thus appears that any private benefit arising from an organization's activities must be "incidental" in both a qualitative and quantitative sense if that organization is to be entitled to exemption under section 501(c)(3). That is, an activity may provide an indirect benefit to private interests, and thus be "incidental" from a qualitative standpoint, but if it provides a substantial benefit to private interests, albeit indirectly, it will negate charitability and exemption under section 501(c)(3). Compare Rev. Rul. 75-286, 1975-2 C.B. 210 with Rev. Rul. 68-14, 1968-1 C.B. 243. [The former describes an organization formed to improve an area adjacent to its members' property which did not qualify for exemption since it operated to serve private interests by enhancing members' property rights as evidenced by its restricted membership and area served; whereas, the latter describes an organization formed to preserve and develop the beauty of an entire city which did qualify for exemption.] On the other hand, if an activity provides a direct benefit to private interests, it does not matter that the benefit may be quantitatively insubstantial; the direct private benefit is "deemed repugnant to the idea of an exclusively public charitable purpose" and the organization cannot be exempt under section 501(c)(3). Supra, at pages 6 through 8.

In applying these standards to the communal religious organization, Chief Counsel first acknowledged that the quantitative distribution of benefits appeared to weigh against exemption for the organization. While the underlying motivation for the organization's activities was religious conviction, it could reasonably be assumed that the public generally was untouched by the organization's activities since its small membership was located in an isolated wilderness area. But, Chief

Counsel pointed out that the public benefit derived from religiously motivated activities is generally viewed as extending to the public even though the persons directly participating in the activity are limited in number. Therefore, the fact that only members derived any immediate tangible benefit from the organization's activities did not cause it to fail the quantitative test. Chief Counsel dealt with the qualitative aspects of the organization's activities (and reaffirmed its analysis of the quantitative test) as follows:

> In our opinion, [the organization's] provision of minimum food and lodging to members primarily furthers its religious purposes. As stated previously, [the organization's members] believe or hold as sincere religious beliefs that they must in order to be true members of the Body of Christ live communally, eat communally, and be mutually interdependent insofar as minimum food and lodging in an isolated wilderness setting are concerned. The provision of minimum food and lodging in this context to [the organization's members] constitutes an indirect benefit which is qualitatively incidental because it is a necessary concomitant to [the organization's] operation as a communal religious organization with its particular religious tenets. The provision of minimum food and lodging is also quantitatively incidental when one considers: the overall benefit to the public derived by the operations of religious organizations or organizations which promote or advance religion in general; the fact that it is through the mutual efforts of [the organization's members] themselves that minimum food and lodging are provided; there is no indication that food and lodging benefits exceed that which is strictly necessary to the continuation of a communal religious life style; and membership in [the organization] is potentially open to any person who will accept and adopt the religious beliefs and life style of [the organization]. Supra, page 16.

While the organization in G.C.M. 38827 provided only the bare necessities to its members, a case involving a more comfortable life style was soon forthcoming. The Alive Fellowship of Harmonious Living was formed to promote the teaching of "polarity," a doctrine that stresses the dual nature of all things. The organization conducted courses in this doctrine on a residential basis at its headquarters and on a nonresidential basis at several outreach centers. Tuition for the courses ranged from $1,500 to $7,500 for a one year course leading toward becoming a Practitioner. After the one year course, persons studying to become Practitioners then devoted two years of service to the Fellowship in some capacity; for example, teaching others to become Practitioners. Upon becoming Full Members, individuals typically donated their assets to the organization although they were not required to do so as a condition of membership. During their two years of service for the Fellowship the Practitioners were supported by the Fellowship in the same way as Staff Members. The approximately sixty Staff or

Full Members of the organization were provided with a nominal cash allowance, room, board, medical care, and whatever other necessities their personal circumstances required, such as assumption of outstanding liabilities including attorney expenses and child support. Liabilities for some members exceeded the value of their donated assets.

The Fellowship applied for recognition of exemption under IRC 501(c)(3). The Service denied its application on two grounds: that the organization was not operated exclusively for exempt purposes and that its net earnings inured to the benefit of private individuals. The organization brought an action for a declaratory judgment in the Tax Court: Alive Fellowship of Harmonious Living, cited above.

Under the theory advanced by Chief Counsel in G.C.M. 38827, the benefits received by the Fellowship's members could be viewed as quantitatively incidental. The organization had a concededly religious purpose, so the public benefit from its activities outweighed any individual benefit to members. But, the benefits to members were arguably not qualitatively incidental because they were in excess of the bare subsistence amount which would have been necessary to accomplish the organization's religious purpose. Therefore, the members were getting an undeserved benefit at the Fellowship's expense and that benefit could reasonably be expected to increase in proportion to the number of new Practitioners attracted to the organization. In other words, a finding of reasonable compensation for services on the part of staff members without running afoul of the inurement proscription would require an analysis that compared the value of room, board, necessities and the assumption of debt with specific reference to the value of the benefit received in relation to the value of the benefit provided through some binding commitment to render future services. Thus, the Full Members of the Fellowship were sharing in the net earnings of the organization.

The Tax Court followed this line of reasoning but employed a rough estimate that the benefits received were "meager" and that their value was reasonable compensation for performing full-time services. The Court brushed aside the Service's argument that a member's compensation was not distributed in accordance with work actually done, but rather on the basis of individual needs. After distinguishing other communal religious organization cases on the ground that they were not decided using the reasonable compensation standard, the Court concluded that the reasonable compensation standard was satisfied.

The Court also analyzed the "substantial nonexempt purpose" argument and found that it was based on the theory that the organization served its members'

private interests rather than the public interest. The Court found this argument to be unsupported by the facts, concluding that the organization had "engaged in no substantial activity which was not directed to the spread of its doctrines to those who had expressed an interest in them." Therefore, the Service's denial of the Fellowship's exempt status was not sustained. In concluding its opinion the court stated as follows:

> We note that petitioner's operations lost money during the years in question, and that even the members' donations did not entirely offset that loss. Should petitioner's activities one day generate net profits, its disposition of those profits will, of course be subject to scrutiny and its exempt status subject to review at that time. Supra, at 1145.

The Alive Fellowship case demonstrates that the characterization of the facts in a particular case may be more compelling than the legal theories used to justify the result. Once the "fact" of reasonable compensation is found, the issue of inurement or private benefit disappears from the case.

2. Facts and Circumstances Control

The discretion inherent in finding and weighing facts can produce results which are difficult to rationalize. In Bethel Conservative Mennonite Church v. Commissioner, 84-2 USTC 9195 (CA 7), rev'g 80 T.C. 352 (1983), the Tax Court had held that an organization which operated a medical aid plan for its members was engaged in substantial nonexempt activity. The basis of the Tax Court's decision was that 22% of the organization's disbursements were paid for medical care of its members, a substantial nonexempt purpose. The Tax Court's decision was reversed on appeal because one of the Church's central tenets was that members should bear one another's burdens. Since the medical aid plan carried this religious tenet into practice, the Circuit Court held that the organization was exempt.

A case factually similar to the Bethel case is Mutual Aid Association of the Church of the Brethren v. U.S., 759 F.2d 792 (10th Cir. 1985). In that case the Court of Appeals affirmed a district court opinion holding that an association that provided only members of the Church of the Brethren with casualty insurance was not entitled to recognition of exemption as a social welfare organization. The Association argued that it was advancing religious principles and that the advancement of religion was a social welfare activity. The Courts held that the Association's activities were not dedicated exclusively or primarily to the

advancement of religion or social welfare because of the presence of a substantial nonexempt purpose - providing property insurance for its members on the basis of assessed premiums.

The different results in Bethel and Mutual Aid Association of the Church of the Brethren may depend on the fact that in the Bethel case the insurance activity was funded by voluntary contributions. No individual received a quid pro quo for his contribution. In Mutual Aid each individual received casualty insurance protection for his own property in exchange for paying his share of the assessed premium. These cases illustrate that even when the facts appear to be similar, variations in the background or circumstances of the case can determine whether the benefit to members disqualifies an organization for exemption.

The underlying problem of member benefit also appears in organizations that engage in neighborhood improvement activities as previously noted when comparing Rev. Rul. 75-286 with Rev. Rul. 68-14, cited above. Such organizations may qualify for exemption under IRC 501(c)(4) if social welfare is primarily advanced even though private interests are served more than insubstantially. They cannot qualify under IRC 501(c)(3) if the private benefit inherent in their activities is more than insubstantial. See the article on Private Benefit, Private Inurement and Community Deterioration in the 1981 CPE course book beginning at page 85. Two recent examples of cases in this area are discussed below.

(a) Flat Top Lake Association, Inc. v. U.S., 868 F.2d 108 (4th Cir. 1989)

The Association bought 2,200 acres of property and constructed an artificial lake on the site. The Association then sold lake front lots to individuals who became members of the Association by reason of their property ownership. The Association built its own private road to serve the development and strictly limited access to the community to its members and their guests. Although the Association reimbursed a governmental entity for watchman's services, it had no governmental authority of its own.

The Association was recognized as exempt under the predecessor to IRC 501(c)(4). In 1979 the Service revoked the Association's exemption because it primarily benefited its members. The Association paid taxes and sued for a refund. The District Court granted the government's motion for summary judgment and the Association appealed.

The Association argued that its activities were directed to all of the inhabitants of the community equally. There was no disproportionate benefit to some members at the expense of the community as a whole.

The Court of Appeals declined to accept this reasoning, concluding that a "community" had to have some meaningful relationship to the general public. Since the Association's activities were directed to maintaining the lake for the exclusive use of its own membership, the Association's relationship with the general public was exactly the opposite of the relationship required to support exemption under IRC 501(c)(4). The Court concluded that the Association could not "claim a tax exemption for benefitting itself" and affirmed the District Court's decision that the Association was not exempt under IRC 501(c)(4).

(b) Columbia Park and Recreation Association, Inc. v. Commissioner, 88 T.C. 1, aff'd by unpublished order (4th Cir. 1/12/88)

The Association was formed in a private real estate development which was neither incorporated nor a political subdivision of any state or county to operate swimming pools, parks, boat docks, and other recreational facilities. It charged fees for the use of some of its facilities with nonresidents paying higher rates. The organization was exempt under IRC 501(c)(4) but sought exemption under IRC 501(c)(3) in order to become eligible to use the proceeds of tax-exempt bonds which might be issued for its benefit. The Service denied the organization's application for recognition of exemption under IRC 501(c)(3) and the organization brought a declaratory judgment action in the Tax Court. The Tax Court concluded that the organization was operated for the substantial nonexempt purpose of providing comfort and convenience to the residents of the community and not for charitable purposes.

(c) Recent Technical Advice Memorandum

Recently, the National Office considered whether a neighborhood improvement organization was exempt under IRC 501(c)(3).

The organization was organized for the purpose of combatting community deterioration and carrying on activities in a particular neighborhood directed to public safety, crime prevention, fire safety and rescue services. The organization was supported by membership dues. Most of its income was expended in contracting with a private company to patrol the public areas within its neighborhood of approximately 320 single family homes. The National Office

concluded that the organization provided an impermissible private benefit to its members:

> While the purpose/activity of providing security to the neighborhood of the contributing members is a laudable one, the private interest inherent in this mutual undertaking contravenes section 1.501(c)(3)-1(d)(1)(ii) of the regulations. The Regulations specifically state that an organization must serve a public rather than a private interest....The private benefit of providing a professional security patrol to organization members to protect their neighborhood outweighs any potentially charitable purpose that may exist....The organization provides a substantial benefit to its members rather than benefiting the general public. Its members are a discrete group who support its activities, and thereby, derive significant reciprocal benefits.
>
> Accordingly, [the organization] will not qualify for exemption under section 501(c)(3) of the Code because it serves private rather than public purposes and, therefore, more than an insubstantial part of its activities are not in furtherance of an exempt purpose.

3. 501(c)(3) Precluded When Private Interests Are Served

The result in all three of the situations discussed above turns on the degree of public benefit inherent in the organization's activities. In Flat Top Lake, the Association provided no benefit to the community as a whole since the general public was purposely excluded from the area controlled by the Association. In the Columbia case and the TAM, although the organizations provided some benefit to the general public, they were still aggregations of residents of a particular area bound together for the purpose of mutual enhancing their own private interests. Since a 501(c)(3) organization must serve a public rather than a private interest, neither organization could qualify under IRC 501(c)(3).

The Columbia case also brings into focus the fact that the prohibition against serving private interests cannot be avoided by merely increasing the size of the class whose private interests are being served. Columbia was a large, planned development with over a hundred thousand residents, including business operators and tenants, as well as home owners. While the prohibition against inurement operates only against insiders, the prohibition against serving private interests operates against all parties who receive a benefit not accorded to the public as a whole.

4. Membership Has Its Privileges

Frequently organizations will offer inducements to the public to encourage membership. For example, museums, symphonies, and other educational and cultural organizations may offer special previews, discounts, or receptions exclusively for members. These promotional offerings are typically considered incidental to the accomplishment of charity since they are usually nominal both in amount and in relation to their purpose of securing increased public funding and participation. However, where the benefits provided members are too personal or private, an organization may fail the operational test. The following cases describe situations in which there is too much private benefit to members.

(a) North American Sequential Sweepstakes v. Commissioner, 77 T.C. 1087 (1981)

Three skydivers formed a nonprofit corporation to promote and conduct a team skydiving exhibition. The exhibition featured a technique known as "sequential relative work," in which teams performed a series of 3 or 4 different maneuvers or formations during a jump.

The organization, through its president, persuaded the United States Parachute Association to sanction its competition and agreed to provide $ 10,000 to the winner of the competition to defray expenses of sending the winning team to South Africa to compete in a World Cup competition in the sport.

A team headed by one of the 3 founders of the organization won the exhibition. The winning team, accompanied by the organization's president, then trained for the World Cup in California and traveled to South Africa where it took second place.

In 1976 the organization received $ 18,518 in contributions, at least $ 14,769 of which was contributed by its president. The remainder was contributed by other persons who participated in the organization's exhibition.

The organization applied for recognition of exemption under IRC 501(c)(3). The Service denied its application on the basis that the organization was not operated exclusively for one or more exempt purposes. The organization brought a declaratory judgment action in the Tax Court.

The organization argued that its primary purpose was to educate the public in understanding the techniques of sequential relative work, thereby promoting amateur athletic competition. The Service argued that the organization's primary

purpose was to hold a recreational event for the benefit of a few skydivers, particularly the organization's founders. The Tax Court agreed with the Service.

The Tax Court noted that the organization's president had taken trips to California and South Africa as a "team leader," even though his team had not won the organization's exhibition. Since this same individual had provided most of the organization's financial support, exemption of the organization would have resulted in the public subsidizing the individual's private recreational pursuits by providing him with deductibility for his contributions to the organization.

Although this case involved tax years prior to the extension of IRC 501(c)(3) exemption to organizations that foster national or international amateur sports competition, the organization's primary purpose of furthering the recreational interest of its creators would have precluded exemption even if the statute had been in its present form. When the Court decided this case, it had already recognized that an organization furthering amateur athletics was entitled to exemption under IRC 501(c)(3). See Hutchinson Baseball Enterprises, Inc. v. Commissioner, 73 T.C. 144 (1979), aff'd, 696 F.2d 757 (10th Cir. 1982). Therefore, it is clear that the organization failed to qualify for exemption because it was not operated exclusively to promote amateur athletics.

(b) The Callaway Family Association, Inc. v. Commissioner, 71 T.C. 340 (1978)

The Association was a nonprofit corporation engaged in researching the genealogy of the Callaway family in the United States. The ultimate objective of the research was to publish a book detailing the family's history from colonial times to the present. The organization held an annual meeting, conducted workshops in genealogy research, and published an annual journal. The organization was supported by dues paid by approximately 600 members throughout the country. The Service denied the organization's application for exemption under IRC 501(c)(3) because more than an insubstantial purpose of the organization was serving the private interest of the Callaway family. The Association brought a declaratory judgment action in the Tax Court.

The Association argued that its activities would contribute to a better understanding of American history by providing an in depth and coherent analysis of family life from colonial times to the present. Therefore, the organization furthered educational purposes. The Association further argued that it was

analogous to a genealogy organization held to be exempt in Rev. Rul. 71-580, 1971-2 C.B. 235.

The Tax Court noted that the Service had, in effect, conceded that the organization did have some educational purposes. However, exemption had been denied not because the organization had no educational purposes, but because its activities taken as a whole were not exclusively in furtherance of exempt purposes. The primary benefit of the Association's activities flowed directly to members of the Callaway family. Any benefit to the general public was clearly a secondary and incidental result of the Association's activities. The Court distinguished Rev. Rul. 71-580 on the ground that the genealogical organization in that case was helping members of the Mormon church adhere to Church doctrine requiring members to attempt to trace their genealogy back to Adam and Eve. This was a religious purpose, which in the general law of charity, is deemed to benefit the public as a whole even though only a limited number of adherents of a particular faith may be directly served.

(c) Manning Association v. Commissioner, 93 T.C. No. 50 (11/15/89)

Descendants of an early New England settler, William Manning, formed the Association. The Association acquired a dwelling house which had been built by a grandson of William Manning. The Association renovated the house, gave it the name "the Manning Manse," and furnished it with colonial artifacts donated by family members. The Association fostered the gathering of genealogical data on Manning descendants, collected family memorabilia, and produced and sold items such as Manning Manse notepaper, cookbooks, bookplates, and the Manning coat-of-arms. A large portion of the artifacts donated by family members was loaned to a university museum.

The Association built an extensive addition to the Manning house, as well as a large parking lot, and leased the premises to an unrelated party for the operation of a restaurant. The restaurant used the historic character of the house in attracting patronage.

The Association applied for recognition of exemption under IRC 501(c)(3). The Service denied the application and the Association brought a declaratory judgment action in the Tax Court.

The Court reviewed each facet of the Association's operations. It found that the Association's "annual meeting" was in reality a family reunion. A newsletter

published by the Association was directed toward promoting family pride and providing family members with an opportunity to share and receive news. The maintenance of genealogical data helped Manning family members in tracing their roots. The addition of facilities for a modern restaurant detracted from the historic character of the building, although the rental of the premises after renovation provided the bulk of the Association's financial support.

The Court acknowledged that the Association's activities did further educational purposes to some degree. Nonetheless, the Court concluded that personal interests and nonexempt family purposes motivated the Association's activities to a substantial degree. The Court also addressed a novel argument raised by the Association:

> Petitioner calls attention to World Family Corp. v. Commissioner, 81 T.C. 958 (1983) [noted in Section 1 of this article], as suggesting, in petitioner's words, that "where a nonexempt function represents less than ten percent of total efforts, the doctrine of 'exclusively' will not be contravened." It then treats that suggestion as a "rule of law" establishing a "10% safe harbor" limitation, and undertakes to show that only about 10 percent of the time was expended by its officers and others on its behalf on matters relating to genealogy while some 90 percent of efforts were devoted to other matters such as negotiating the lease, etc. However, even though some portion of that 90 percent undoubtedly relates to exempt educational purposes, much, if not most, of it relates to nonexempt purposes. Certainly, the nonexempt purposes, including private family interests and the leasing and improvement of the premises for the conduct of a commercial restaurant business, represents a very substantial aspect of petitioner's operations. Moreover, contrary to petitioner's position, World Family Corp. v. Commissioner establishes no such 10 percent safe harbor rule. The Court there stated (81 T.C. at 967, n. 10):
>
> > We establish no general rule for future cases in finding 10 percent to be insubstantial. We noted a similar caveat in Church in Boston in which we found approximately 20 percent of expenditures to constitute more than an insubstantial activity: "We hasten to point out that while the facts in the instant case merit a denial of exempt status to petitioner, we do not set forth a percentage test which can be relied upon for future reference with respect to nonexempt activities of an organization. Each case must be decided upon its own unique facts and circumstances." Church in Boston v. Commissioner, 71 T.C. 102, 108 (1978).
>
> This case must also be decided upon its own unique facts and circumstances. It is unnecessary for us to "make a determination based upon some economical and moral calculus....It is sufficient only to find, as we do, that 'more than an

> insubstantial part of its activities is not in furtherance of an exempt purpose'." Christian Stewardship Assistance, Inc. v. Commissioner, 70 T.C. 1037, 1042 (1978). Petitioner's activities, whether viewed separately or in the aggregate, demonstrate that substantial private and noneducational interests are being served.

5. The Burden of Proof

Regs. 1.501(c)(3)-1(d)(1)(ii) states that the burden of proof is upon the organization to establish that it is not organized or operated for the benefit of private interests. This requirement applies equally to inurement and private benefit issues. While it is difficult to prove a negative, the organization is certainly in a better position than the Service to know the detailed facts surrounding its formation and operation. Therefore, in an exemption application case the organization is required to furnish the Service with the documents setting forth its purposes and rules of operation as well as a detailed explanation of its operations. See Rev. Proc. 84-46, 1984-1 C.B. 541.

Failure to provide relevant information is a sufficient basis for both the Service and the courts to refuse to recognize the organization as exempt. This reduces the possibility that an organization may take refuge in a gray theoretical area or retreat into claims of ignorance about its own operations. Simply put, the organization must establish the factual basis for its exemption.

Since inurement and private benefit issues are highly fact dependent, the courts do not look with favor on an organization's failure to provide relevant facts and they are not hesitant to find that an organization has failed to carry its burden. See Gondia Corporation v. Commissioner, T.C. Memo. 1982-422; Schoger Foundation v. Commissioner, 76 T.C. 380 (1981); The Basic United Ministry of Alma Karl Schurig v. Commissioner, 670 F.2d 1210 (1982); First Libertarian Church v. Commissioner, 74 T.C. 396 (1980); Church of Gospel Ministry, Inc. v. U.S., 58 AFTR 2d 86-5232 (D.C. D.C. 1986); Universal Bible Church, Inc. v. Commissioner, T.C. Memo. 1986-170.

In the Founding Church case, cited and summarized earlier, the organization could offer no convincing explanation as to why payments and other benefits were conferred on the organization's founder and members of his family. In Church of Scientology of California, cited above, the Tax Court took particular note of the fact that the organization had failed to produce its accountant or other responsible fiscal officer to give testimony in the case. In Pius XII Academy v. Commissioner, T.C. Memo. 1982-97, denial of exemption to an organization that could not furnish

a detailed explanation of how it intended to operate as a "typical Catholic parochial school" was sustained. In Cleveland Chiropractic College v. Commissioner, 63-1 USTC 9200 (8th Cir. 1963), a negligence penalty was imposed when the organization's auditor testified that its books were incomplete for the taxable years at issue due to a lack of effective control over cash.

A. American Campaign Academy

The failure to provide information need not consist of an outright refusal. If the information is relevant the organization may be required to produce a concrete and responsive answer. Information which is superficially responsive but that dances around the factual point at issue justifies a finding that the facts being avoided would be detrimental to the organization. A recent case in point is American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989).

The Academy operated a school that provided a 10-week training program for persons who wished to participate in political campaigns in responsible positions such as communications director, finance director, or campaign manager. The organization's application for exemption disclosed that it was an outgrowth of a course of instruction offered by the National Republican Congressional Committee. One of the organization's three initial directors was the Executive Director of the NRCC. Another initial director was a member of the Republican National Committee. Two of the Academy's six full-time faculty members were previously involved in the NRCC's training program.

The Academy furnished copies of its newsletters in support of its application. The newsletter indicated that 85 of 120 graduates were employed by named politicians, political candidates, or political organizations. The Service asked the Academy to identify the political party affiliation of the politicians, political candidates, and political organizations for whom its graduates worked. The Academy responded that--

> [w]e do not require students to remain in contact with the Academy following graduation. Of those who chose to do so, some have informed the Academy of the identity of the candidate(s) for whom they are working....To the best that can be determined, the predominant party affiliation of the candidates for whom graduates are working in 1986 is Republican, but the Academy has no exact numbers. Supra, at 1061.

The Tax Court treated this response as the equivalent of an admission that no candidates other than Republican candidates were served by the Academy's graduates. In explaining the reasons for its conclusion, the Court made the following comments.

> A showing that petitioner's graduates served in Congressional and Senatorial campaigns of candidates from both major political parties in substantial numbers would have significantly aided petitioner's contention that its activities only benefited nonselect members of a charitable class. Nevertheless, petitioner did not see fit to include in the administrative record any specific example of a graduate working for a Democratic Senatorial or Congressional candidate. We cannot assume that information regarding the placement of Academy graduates, not shown to be unavailable, would have been favorable to petitioner; i.e., would have reflected nonpartisan placement. In fact the contrary is true. See Fee v. Commissioner, T.C. Memo. 1989-211; see also Wichita Terminal Elevator Co. v. Commissioner, 6 T.C. 1158 (1946), aff'd, 162 F.2d 513 (10th Cir. 1947). Consequently, it is reasonable to infer from petitioner's omission that the affiliation information, had it been included would have revealed the Republican affiliation of the candidates. Supra, at 1072.

The Court's conclusion that the Academy had intentionally avoided providing the information requested was based on the fact that the Academy included the study of the Federal Election Commission rules and regulations in its curriculum. Therefore,

> petitioner would have to concede that it is peculiarly positioned to have knowledge and awareness of the ready availability of data from the Commission's public records. Accordingly, we infer that petitioner's "best determination" regarding the predominant Republican party affiliation of the candidates for whom Academy graduates were working in 1986 reflects the political affiliations disclosed in the Federal Election Commission's public records. Supra, at 1072.

Since the organization had sufficient information and expertise to provide a concrete answer to the Service's inquiry by matching the reports of its graduates' activities with the records of the FEC, its failure to do so justified a finding of fact against the organization. The finding of fact was used to support the conclusion

that the Academy operated for the benefit of Republican party entities and candidates. Therefore, the denial of the Academy's exemption was sustained.

6. Problems Involving Multiple Entities

A. The Problem

An individual cannot be exempt under IRC 501(c)(3) since the statute exempts only "corporations, and any community chest, fund or foundation" that satisfies the organizational and operational test. However, creating a corporation is a simple matter and drafting the provisions required to satisfy the organizational test is easy. The possibility therefore exists that an individual or a business enterprise may utilize the formal trappings of an exempt organization in an attempt to shelter income from federal income tax. This was the situation addressed in Rev. Rul. 69-279, 1969-1 C.B. 152.

B. A Simple Case

In Rev. Rul. 69-279 a medical doctor created an organization which he controlled. The organization then employed the doctor to conduct a program of "medical research" which consisted of the doctor treating his patients on a fee for service basis. The organization was held not to be exempt underIRC 501(c)(3) because it served the doctor's private interest. See Rev. Rul. 81-94, 1981-1 C.B. 330, summarized above, for a similar result involving an alleged church which supported its minister out of his/her "donations" from outside employment as a nurse. Tax avoidance schemes utilizing only one corporate entity to funnel benefits to an individual are relatively easy to spot. The creation of a number of corporate entities provides additional layers of factual and legal relationships to be unraveled. However, the use of multiple corporate entities to produce inurement or private benefit does not defeat the proscription.

C. More Complex Cases

1. Church By Mail, Inc.

In Church by Mail, Inc. v. Commissioner, T.C. Memo. 1984-349, aff'd, 765 F.2d 1387 (9th Cir. 1985), a "church" formed by two evangelists engaged in occasional revivals, sometimes in cooperation with another "ministry" corporation operated by the same individuals. The principal activity of both organizations was

the mailing out of low cost items such as prayer clothes and vials of holy water accompanied by a solicitation for donations.

The two evangelists who incorporated the church also incorporated a direct mail company. The church contracted with the direct mail company to provide and mail its solicitation materials. The direct mail company purchased computer services from a data processing corporation whose stock was owned by the two evangelists. The church, the ministry, the direct mail company, and the data processing firm employed the two evangelists and members of their families. No persons who were not family members were employed by any of the corporations. The church operated at a loss because the expense of its direct mail campaigns exceeded the income it received as a result of the campaigns. The church was only able to keep operating because the direct mail company made loans and advances to it.

The Court refused to confine its analysis to the church alone and considered all of the payments made to the two evangelists and members of their families by the direct mail company as well. After reviewing this evidence the Court concluded that the church was "operated for the substantial nonexempt purpose of filling the pockets of" the two evangelists and their families and that it had failed to carry its burden of demonstrating otherwise. The Court upheld the Service's determination that the church was not exempt under IRC 501(c)(3).

In 1987 Church By Mail sued the Service claiming that it had cancelled its contract with the direct mail company and charged that individually named IRS employees had exceeded the bounds of their authority and had violated various unspecified laws. The Court found that the mere cancellation of the advertising contract did not stop the flow of funds to the ministers and that the organization had already had an adequate opportunity to vindicate its claims in the Tax Court and Ninth Circuit proceedings. The "vague and conclusory" charges against the Service and the individually named employees were also dismissed. Church by Mail, Inc. v. U.S., No. 87-0754-LFO (D.D.C. 11/28/88).

The Tax Court buttressed its opinion in Church by Mail by stressing the element of dual control of the church and the direct mail company by the evangelists. This supported the Service's conclusion that the prohibition against private inurement had been violated. However, formal legal control is not necessary if the facts demonstrate that one corporation in fact conducts its business through another.

2. est of Hawaii

est of Hawaii v. Commissioner, 71 T.C. 1067 (1979), aff'd, 647 F.2d 170 (9th Cir. 1981), involved the marketing of a self realization program developed by Werner Erhard and known as "Erhard Seminar Training." Rights to commercially exploit the program were held by EST, Inc., a for profit corporation. In 1973 a franchise system was created whereby EST, Inc., would relinquish its operations in a particular geographic area to a local tax-exempt corporation. EST, Inc., through one or more intervening corporations, would supply qualified personnel to staff the organization, furnish materials needed to conduct the organization's activities, and assure that the organization conducted its activities in conformity with the standards of EST, Inc.

est of Hawaii was a corporation formed in Hawaii to act as a local provider of est services. It conducted training programs for fees and out of the fees it paid its operating expenses and a franchise fee which entitled it to use the EST methods, name, and materials.

est of Hawaii applied for recognition of exemption under IRC 501(c)(3). The Service ruled that the organization was not operated exclusively for exempt purposes because it served private commercial interests. The organization sought a declaratory judgment in the Tax Court.

est argued that it had no commercial purpose itself. Payments for its franchise were ordinary and necessary expenses. It was entirely independent from its franchiser.

The Tax Court disagreed. Since the franchise arrangements controlled the tuition fees the Hawaii organization could charge, set the minimum number of students it must serve, supplied the programs it would use, and provided the personnel to manage the organization, est of Hawaii was left with no function

> except to present to the public for a fee ideas that are owned by International [one of the intervening corporations] with materials and trainers that are supplied and controlled by EST, Inc. Under these circumstances it cannot be said that petitioner has made payments to a corporation with which it had no connection whatsoever. Supra, at 1080.

Since the existence and operation of the direct customer service corporations was an essential element in the generation of income for the for-profit corporations, the Court concluded that est of Hawaii was itself engaged in commercial activity for the benefit of the for-profit corporations.

3. G.C.M. 39326

Since interrelationships among corporations may result in private benefit or inurement, corporate structures containing a multiplicity of exempt and nonexempt components deserve close scrutiny. In G.C.M. 39326 (August 31, 1984), Chief Counsel addressed such a case.

The issue arose from the revocation of the exemption of an organization that provided hospital management and support services. The organization provided its services to exempt and nonexempt hospitals, government agencies, educational institutions, and for profit entities. The organization's exemption was revoked when the Service concluded that providing services to commercial enterprises had become a substantial part of the organization's activities. The organization brought a declaratory judgment action in the Claims Court.

While the declaratory judgment case was pending the organization developed a plan of reorganization as part of a proposed settlement. The reorganization plan envisioned the creation of three taxable corporations which would undertake the activities that the Service had found to be substantial nonexempt activities. The three taxable corporations would be subsidiaries of a taxable holding company, all of the stock of which would be held by an exempt holding company. The exempt holding company would also serve as the parent in the overall structure which would include a number of nonprofit hospitals.

The exempt holding company would appoint the board of directors of the taxable holding company, subject to the restriction that a majority of the taxable holding company's Board would not consist of Directors, officers, or employees of any of the exempt corporations in the structure. Appointments to the Boards of the taxable subsidiaries would be similarly restricted. All of the taxable corporations would distribute their earnings to the exempt holding company parent. The question was whether the activities of the taxable corporations could be attributed to the exempt holding company parent. The Exempt Organizations Technical Division concluded that in spite of the formal corporate separation, the commercial activities would continue to be conducted by the exempt holding company parent

acting through the taxable corporations. Chief Counsel disagreed, reaffirming a longstanding position that

> an attempt to attribute the activities of a subsidiary to the parent "should be made only where the evidence clearly shows that the subsidiary is merely a guise enabling the parent to carry out its...activities or where it can be proven that the subsidiary is an arm, agent, or integral part of the parent. Supra, at 4.

Chief Counsel advised that the burden would be on the Service to prove by clear and convincing evidence that the subsidiaries lacked corporate integrity, a difficult standard to meet given the case law in the area.

> For federal income tax purposes, a parent corporation and its subsidiary are separate taxable entities so long as the purposes for which the subsidiary is incorporated are the equivalent of business activities or the subsidiary subsequently carries on business activities. Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438 (1943); Britt v. United States, 431 F.2d 227, 234 (5th Cir. 1970). That is, where a corporation is organized with the bona fide intention that it will have some real and substantial business function, its existence may not generally be disregarded for tax purposes. Britt, 431 F.2d at 234. However, where the parent corporation so controls the affairs of the subsidiary that it is merely an instrumentality of the parent, the corporate entity of the subsidiary may be disregarded. Krivo Industrial Supply Co. v. National Distillers and Chemical Corp., 483 F.2d 1098, 1106 (5th Cir. 1973); 1 W. Fletcher, Cyclopedia of the Law of Private Corporations para. 43.10 (Perm. Ed. 1983). Supra, at 4.

Chief Counsel concluded that the independent Board and statements by the exempt holding company parent that it would not be involved in the day-to-day management of the taxable holding company and its subsidiaries provided the required degree of separation to assure corporate integrity for the organizations in the new structure. Therefore, the activities of the taxable corporations could not be attributed to the exempt holding company parent.

4. Orange County Agricultural Society

A recent case involving multiple organizations is Orange County Agricultural Society v. Commissioner, T.C. Memo. 1988-380. Three organizations

were involved--an agricultural society, a convenience corporation, and a for-profit corporation. All three organizations were controlled by officers of the Society and/or their transferees.

The Society was formed in 1866 to take over ownership of a fair grounds and to conduct an annual agricultural fair. It was organized as a stock company, the stock being held at various times by different officers of the organization.

The convenience corporation was formed to operate a racetrack located on the fair grounds. Its stock was held by the same officers who held the Society's stock. Originally, the track was used for horse racing. Later, it was used for automobile racing. The Society leased the race track to the convenience corporation. Automobile races were held on 24 to 25 Saturdays of each year. A demolition derby was held during the agricultural fair.

The for-profit corporation was formed by one of the officers of the Society. It leased land adjacent to the fair grounds to the Society to provide it with extra parking during the 9 to 12 day period each year when the fair was in progress.

The Service revoked the Society's exemption under IRC 501(c)(3) on two grounds: (1) the Society's involvement in the stock car racing comprised more than an insubstantial part of its activities; and (2) the Society made interest-free, unsecured loans to the other two corporations which resulted in serving a private rather than public interest. The Court agreed on both counts. The unsecured, interest-free loans consisted of loans made, without repayment date, to enable the convenience corporation to meet its annual start up costs and loans made to the for-profit corporation whose land it leased for parking.

The Court concluded that since the same officers and/or their transferees were involved in the operation of all three corporations, the unsecured, interest-free loans had resulted in inurement of the Society's lost interest earnings to the benefit of private interests, which also violated the broader private interest standard of the operational test as follows:

> An organization is not operated exclusively for an exempt purpose unless it serves a public rather than a private interest; thus, an organization must establish that it is not operated for the benefit or private interests, such as designated individuals, the creator, shareholders of the organization, or persons controlled (directly or indirectly) by such private interests. Sec. 1.501(c)(3)-1(d)(1)(ii),

Income Tax Regs. See Callaway Family Association v. Commissioner, 71 T.C. 340 (1978); Baltimore Health and Welfare Fund v. Commissioner, 69 T.C. 554 (1978). In this regard, the exempt organization's net earnings cannot inure, in whole or in part, to the benefit of private shareholders or individuals, i.e., persons having a personal and private interest in the activities of the organization. Sec. 1.501(a)-1(c)(2), Income Tax Regs. Net earnings include more than net profits and may inure to an individual in more ways than in the distribution of dividends. Harding Hospital, Inc. v. United States, 202 F.2d 1068 (6th Cir. 1974); General Contractors' Assn. of Milwaukee v. United States, 202 F.2d 633 (7th Cir. 1953); Chattanooga Auto, Club v. Commissioner, 182 F.2d 551 (6th Cir. 1950), aff'g 12 T.C. 967 (1949); Unitary Mission Church v. Commissioner, 74 T.C. 507, 513 (1980), aff'd without published opinion 647 F.2d 163 (2d Cir. 1981); Founding Church of Scientology v. United States, 188 Ct. Cl. 490, 497, 412 F.2d 1197, 1200 (1969), cert. denied, 397 U.S. 1009 (1970); Lowry Hospital Association v. Commissioner, 66 T.C. 850, 857 (1976). Supra, at 1605.

D. Congressional Response

The problems that arise when multiple entities are associated with a 501(c)(3) organization prompted the enactment of new IRC 6033(b)(9) as part of the Revenue Act of 1987 (OBRA), which requires IRC 501(c)(3) organizations to include information in their annual returns concerning direct or indirect transfers to, and direct or indirect transactions or relationships with, organizations described in IRC 527 (political organizations) and in IRC 501(c) other than 501(c)(3) under Treasury prescribed regulations or forms. IRC 6033(b)(9) has been implemented by the addition of a new Part VII to the Form 990, Schedule A, for years beginning after December 31, 1987. Part VII requires the reporting organization to provide information regarding transfers, transactions, and relationships with other organizations. Transactions with other 501(c)(3) organizations are excluded from the reporting requirement, as are one-time only transactions with otherwise unrelatedorganizations. The intended effect of the reporting requirement is that all direct and indirect transactions and transfers between the reporting organization and its related or affiliated organizations are to be reported on Schedule A of Part VII, exclusive of contributions or grants received by the reporting organization.

The instructions for Part VII of Schedule A states as follows:

> [A] section 501(c)(3) organization is considered to be affiliated with or related to another non-section 501(c)(3) organization if they share some element of common control OR if a historic and continuing relationship exists between the two organizations. An element of common control is present when one or more of the officers, directors, or trustees of one organization are elected or appointed by officers, directors, trustees, or members of the other. Similarly, an element of common control is present when more than 25 percent of the officers, directors, or trustees of one organization serve as officers, directors, or trustees of the other organization.
>
> A historic and continuing relationship exists when two organizations participate in a joint effort or work in concert toward the attainment of one or more common purposes on a continuous or recurring basis rather than on the basis of one or several isolated transactions or activities. Such a relationship also exists when two organizations share facilities, equipment, or paid personnel during the year, regardless of the length of time the arrangement is in effect.
>
> When the control factor or the historic and continuing relationship factor (or both) is present at any time during the year, the relationship must be reported....

7. Inurement, Private Benefit, and Self-Dealing in Private Foundations

A. Tax Avoidance Schemes

As organizations described in IRC 501(c)(3), private foundations are subject to the same requirements as other organizations described in that section. Additional restrictions, with excise taxes imposed for violations, apply to private foundations notably for purposes of this article regarding acts of self-dealing with disqualified persons. Because the reporting requirements for private foundations are more extensive than for public charities and the statutes governing their operations are more complex, private foundations generally rely on accounting and legal advice in structuring their operations. This helps to avoid unintentional violations of the self-dealing prohibitions. Intentional violations still occur.

1. Art

Martin S. Ackerman Foundation v. Commissioner, T.C. Memo. 1986-385, involved a small private foundation created by an attorney who specialized in art related legal matters. The attorney and his wife were sole shareholders in Sovereign American Arts Corp. (Sovereign), a private art dealer.

After eleven years of being funded solely by Mr. Ackerman, the foundation began receiving "contributions" from individuals who had purchased paintings, books, and other works of art from Sovereign. In return for their purchases, Mr. Ackerman, in his role as trustee of the foundation, would assist the individuals in donating the art works they had purchased to museums. In lieu of receiving a fee for this assistance, Mr. Ackerman would suggest that the individuals should make a "contribution" to the foundation. The value of the contribution would then be deducted on the individual's income tax return. The Court held that the foundation's activities benefitted the private interests of Mr. Ackerman by attracting clients to his law practice and increasing the profits of the art dealer, Sovereign.

2. And Artifice

Recently, the National Office cited the Ackerman case in sustaining revocation of the exempt status of a private foundation which had been formed by a husband and wife to take possession of their collection of various art works. During several years the husband and wife donated 126 art pieces to the foundation and claimed charitable deductions based on their presumed value of $ 365,800.00. The donated pieces of art received by the foundation were placed in storage at a storage company. The donated pieces of art were never removed from their room for exhibition or study purposes. However, the foundation did furnish various works which had been loaned to it by the husband and wife to other museums for display.

Valuations of the art works were performed by an associate of the husband. Excess charitable contributions for 1983 were carried over by the husband on his tax returns.

The art pieces donated by the husband and wife to the foundation were reviewed and valued by the Internal Revenue Service Engineering and Valuation Branch through the Commissioner's Art Advisory Panel. The Panel reviewed 106 of the art pieces and concluded that they had been valued at more than twice their actual fair market value.

The National Office advised that the foundation's acceptance of the works of art from the husband and wife served two purposes: (1) an exempt educational purpose of creating a body of art work for display and study, and (2) a private purpose of lending itself to a scheme to provide for inflated contribution and carryover deductions for the husband and wife of art works unlikely to be used for display or study. Since the public had no access to the works in storage, the benefits associated with these works did not flow to the public. Although there was some public benefit served by the foundation's allowing loaned art works to be displayed in other museums, the National Office concluded that this public benefit was minimal in comparison to the private interest served by the foundation's activities. Therefore, the foundation was operated primarily to serve the private interest of its founders. That it had effectively done so was shown by the fact that the scheme had purportedly reduced the federal income tax liability of the founder. The claimed reduction in income tax liability of the founder was a private benefit which constituted inurement. The organization was therefore not exempt on two grounds--it was not operated exclusively for exempt purposes and its activities resulted in inurement to its founders.

B. Permissible Benefits to Disqualified Persons

Self-dealing is broadly defined in IRC 4941 as the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation. However, there are exceptions to this general rule. An exception for incidental and tenuous benefits is contained in Regs. 53.4941(d)-2(f)(2). The regulation states that

> the fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing. Thus, the public recognition a person may receive, arising from the charitable activities of a private foundation to which such person is a substantial contributor, does not in itself result in an act of self-dealing since generally the benefit is incidental and tenuous.

The regulations do not define the meaning of incidental ortenuous. Therefore, other sources of authority have to be considered in determining whether a benefit is incidental or tenuous.

There is no authority focusing on the meaning of tenuous. Whether a benefit is incidental is determined using the quantitative and qualitative standard discussed

earlier. Since the concept of incidental benefit arises in IRC 501(c)(3) cases, authorities dealing with public charities and pre-1969 foundations can be useful authority in determining whether a particular benefit is incidental. The principle authorities are briefly summarized below.

1. In Rev. Rul. 66-358, 1966-2 C.B. 218, a corporation created a tax-exempt charitable and educational organization and contributed to it property adjacent to the corporation's plant cite for use as a public park. The corporation continued to use as its brand symbol a picture of a certain scenic view in the park. The corporation's use of the scenic view in its brand symbol did not adversely affect the exempt status of the educational and charitable organization under IRC 501(c)(3).

2. Rev. Rul. 73-407, 1973-2 C.B. 383, holds that the benefit to a disqualified person was incidental and tenuous where a private foundation conditioned a grant to a public charity on the change of the public charity's name to that of the disqualified person.

3. In Rev. Rul. 80-310, 1980-2 C.B. 319, a private foundation made a grant to an exempt university to establish an educational program providing instruction in manufacturing engineering that would be useful to a corporation that was a qualified person with respect to the foundation. The corporation intended to hire graduates of the new program and planned to encourage its employees to enroll in the program. However, it did not receive preferential treatment in recruiting graduates or enrolling its employees. The grant was not an act of self-dealing under IRC 4941 because the benefit to the disqualified person was incidental and tenuous.

4. Rev. Rul. 85-162, 1985-1 C.B. 275, involved loans by a private foundation to finance construction projects in disadvantaged areas. Some of the contractors involved in the construction projects banked with a bank who was a disqualified person in relation to the foundation. The revenue ruling holds that any benefit to the bank resulting from ordinary banking and business relations with such contractors would be incidental or tenuous.

5. Chief Counsel again considered the issue of incidental or tenuous benefit in G.C.M. 39741 (July 20, 1988). The G.C.M. deals with two cases which involved placement of sculpture on the private property of disqualified persons.

In Case 1, the founders of an exempt private foundation owned and lived on an eleven acre estate. They donated 26 large sculptures which were displayed on

the grounds of the estate to the private foundation. Almost 300 people a year attended tours of the grounds and viewed the collection. The key District Office sought technical advice as to whether the arrangement between the foundation and the founders constituted self-dealing.

In Case 2, a corporation's headquarters was located on a 112 acre tract of land. The corporation acquired 30 large sculptures which it displayed on property surrounding its headquarters building. Approximately 30,000 people visited the property annually. The corporation created a foundation to which it proposed to donate the sculpture. The foundation applied for recognition of exemption under IRC 501(c)(3).

Chief Counsel used the quantitative and qualitative analysis set forth in G.C.M. 37892, discussed above, and pointed out that even if the private benefit is quantitatively insubstantial in the context of the overall public benefit conferred by the activity, any "direct" private benefit will prevent exemption.

In both Case 1 and Case 2, private interests received a direct benefit. In Case 1 the sculptures were located near the house and pool of the founders. The founders retained ownership of the property even though the sculptures were donated to the foundation. The founders thus continued to enjoy the use of the property and the enhanced aesthetic qualities of its associated with the sculpture. In Case 2 the corporation retained ownership of the land and continued to use the sculpture to beautify the grounds surrounding its corporate headquarters. Therefore, in both cases private interests received direct benefits from the sculptures. This was true even though the public benefit may have been considerable, particularly in Case 2. The direct benefits to private interests disqualified both organizations for exemption under IRC 501(c)(3).

8. Case Examples of Inurement/Private Benefit in Various Types of Organizations

A. Educational and Cultural Organizations

1. Hancock Academy of Savannah, Inc. v. Commissioner, 69 T.C. 488 (1979)

Stockholders in a for-profit private school formed a non-profit corporation to facilitate expansion of the school. The nonprofit corporation leased facilities from the for-profit corporation and purchased the operations of the school for grades 4 and up for $50,000. The $50,000 was alleged to be a payment for goodwill. The

nonprofit corporation continued a policy of the for-profit school whereby parents in addition to paying tuition were required to make interest free loans to the school of $500 for the first child and $100 for each additional child. The loans were repayable in one year. Held, the payment for goodwill was excessive in view of the fact that the operations of the nonprofit organization were expected to produce not profits but losses. The interest free loans benefitted the for-profit corporation because the lease required the nonprofit corporation to use its funds to improve the facilities leased from the for-profit corporation, relieving the for-profit corporation of the need to finance the building improvements at market rates of interest. Thus, sales, transfers, and lease-back arrangements between related parties should be closely scrutinized, including obtaining fair market value appraisals which can be reviewed, as needed, by the Service's valuating experts.

2. Birmingham Business College v. Commissioner, 276 F.2d 476 (5th Cir. 1960)

A brother and two sisters established and operated a private business college and shared net proceeds of the school's operations. Held, the school was an ordinary business enterprise which distributed substantial portions of its net earnings to private individuals.

3. American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989)

See the discussion under The Burden of Proof in Section 5 of this article.

4. Martin S. Ackerman v. Commissioner, T.C. Memo. 1986-385

See the discussion under Inurement, Private Benefit, and Self-Dealing in Private Foundations in Section 7 of this article.

B. Religious Organizations

1. Western Catholic Church v. Commissioner, 73 T.C. 196 (1979), aff'd by unpublished order (7th Cir. 1980), cert. denied, March 9, 1981

The organization's primary activity was the passive investment of funds derived primarily from its founder who, along with members of his family, controlled the organization. The organization stated that its was attempting to

accumulate $500,000 in order to erect a church building. Meanwhile, it engaged in no religious activities. Held, the organization was not operated exclusively for exempt purposes and it failed to establish that no part of its net earnings inured to the benefit of private individuals.

2. U.S. v. Daly, 756 F.2d 1076 (5th Cir. 1985)

Jerome Daly, a disbarred attorney, sold church charters along with instructions and forms for the charter purchasers to use in claiming that all of their income was tax exempt. The charter purchaser would execute a vow of poverty and assign all of his income to his personal church. The charter purchaser would then claim that his income was not taxable to him but to his local church. In fact, each purchaser continued to have complete control over his income and property and lived just as he had before the vow of poverty and assignment. The District Court found and the appellate court affirmed that the vows of poverty and purported assignments were fraudulent and the local churches were not entitled to exemption under IRC 501(c)(3).

3. Calvin K. of Oakknoll v. Commissioner, 69 T.C. 770 (1979), aff'd by unpublished order (2nd Cir. 1979)

Petitioners, husband and wife, founded the Religious Society of Families. The society's religious tenets included the concept that married couples were charged with the religious duty of managing the earth's life support system. They could fullfil this tenet by caring for and preserving a plot of land. Petitioners donated 50 acres of land to the Society and made good faith efforts to attract other couples to occupy portions of the property. However, their efforts were unsuccessful. Held, since the land would revert to the control of the petitioners in the event of dissolution, the Society's assets were not dedicated to an exempt purpose and petitioners could not claim a charitable deduction for their contribution of land to the organization.

4. Universal Life Churches

A continuing stream of cases involving the deductibility of contributions to local Universal Life Churches has been before trial and appellate courts for years. In every case the courts have ruled adversely to the ULC on its contention that denial of the contributions deduction would violate the contributor's Constitutional rights. In Kalgaard v. Commissioner, 764 F.2d 1211 (9th Cir. 1985), in addition to upholding disallowance of contributions to a ULC congregation, the court imposed

double costs and $1,000 attorney's fees against Kalgaard and his counsel. The sanctions were based on a determination that the filing of an appeal was clearly frivolous. The Court stated that because of the attorney's representation in the case of Hall v. Commissioner, 792 F.2d 632 (9th Cir. 1984), he was on notice of the law governing the case and the lack of merit in the appeal. The same result was reached in another ULC case involving the same attorney. Larson v. Commissioner, 765 F.2d 939 (9th Cir. 1985).

5. Televangelists

(a) The Problem

As noted above, there are remedies short of revocation for an act of self-dealing by a private foundation. There are no intermediate remedies for similar acts by public charities. The seemingly harsher treatment for public charities is offset to some extent by the fact that non-insider involvement in public charities can serve to deter inurement schemes. However, the deterrent effect of public involvement may be negligible if the insider is a charismatic figure who can easily influence those who are presumably performing the watchdog function.

(b) Congressional Subcommittee Hearings

In 1987, in the wake of allegations of misuse of funds by well known evangelists, Congress began to look at this problem in relation to television ministries. The Staff of the Joint Committee on Taxation published an Overview of Tax Rules Applicable to Exempt Organizations Engaged in Television Ministries on October 5, 1987. The following day the Oversight Subcommittee of the House Ways and Means Committee held hearings on enforcement and compliance with the tax requirements by television ministries.

Then Commissioner Lawrence Gibbs pointed out in his testimony before the Subcommittee that a television ministry that claimed to be a church could consider itself exempt from the notice requirements of IRC 508. Further, if the organization concluded that it was a church, it would not have to file information returns. Finally, if the Service did attempt to examine the organization, the organization could avail itself of the procedural protections of IRC 7611. This statutory scheme was designed to minimize government involvement in internal religious affairs of a church.

After the hearings on television ministries, the Subcommittee directed the Service to provide quarterly status reports on developments concerning media evangelists. Shortly after the first quarterly report was issued in 1988, the General Accounting Office published a report which had been requested by a member of the House Ways and Means Committee. The GAO report described the Service's procedures for reviewing compliance by churches and other religious organizations and noted the difficulty of monitoring compliance by organizations which are generally exempt from the usual filing and audit procedures. The report concluded that this forced the Service to rely on information from the public and news media in attempting to enforce compliance by religious broadcasters, among others.

(c) Revocation of PTL

While Congress was gathering information on this and other exempt organization areas for possible legislative action, media attention was focused on litigation involving televangelists James and Tammy Faye Bakker and their PTL Ministry.

PTL was founded in the early 1970's. It initially filed Forms 990. In 1976 it stopped filing 990s. The Service commenced an examination of PTL in 1985. By December, 1987 the Service was completing the examination and PTL was in the bankruptcy court. See In re Heritage Village Church a/k/a PTL, PTL Club, etc. v. James O. Bakker, Tammy Faye Bakker, and David A. Taggert, 92 B.R. 1000 (Bankr. D.S.C. 1988). The Service revoked the exemption despite the opposition of the Bankruptcy Court. The Court apparently was concerned that revocation would punish the organization for wrongs of former leaders who were no longer in charge of the organization and destroy any opportunity it might have for getting its financial affairs in order.

The revenue agent's report filed with the Bankruptcy Court revealed that although PTL had a Board of 6 or 7 persons, some Board members were insiders. The unrelated Board members received contributions for their own ministries for their service on the Board. While nominally independent, the Board functioned as a rubber stamp, approving without discussion unspecified amounts of "bonuses" for the Bakkers which amounted to millions of dollars. The Board was never shown financial statements of any kind, did not have regularly scheduled meetings, and met only 2 to 4 times per year. In addition to their "bonuses," the Bakkers drained millions of dollars from their ministry through excessive salaries, expenses, and fringe benefit payments.

In October, 1989 Robert I. Brauer, Assistant Commissioner (Employee Plans and Exempt Organizations), addressed a meeting on tax planning at New York University. In discussing the PTL case, Mr. Brauer noted that PTL had been able to take advantage of the statutory scheme designed to protect churches from unreasonable government interference. Mr. Brauer said that the case should be used to bring the problems inherent in the church audit procedures to the attention of the religious community, Congress, and the Treasury Department. As currently written the statutory protections are available to any organization claiming to be a church. This complicates enforcement. Further, with no enforcement tool other than revocation the Service is in a poor position to curb abuses, since its only remedy is to punish the organization even though the actual wrongdoing may be traceable to particular individuals who have taken advantage of the organization as well as the public at large. Mr. Brauer suggested that sanctions similar to those applied to private foundations and disqualified persons might be applied to public charities in order to discourage the type of abuse which occurred in the PTL case.

C. Hospitals

1. Lowry Hospital Association v. Commissioner, 66 T.C. 850 (1976)

This case involved a nonprofit hospital founded by a physician who maintained his private office in the hospital building. The hospital made unsecured, below market loans to a nursing home founded by the physician. Held, a portion of the hospital's net earnings inured to the benefit of the physician.

2. Harding Hospital v. Commissioner, 505 F.2d 1068 (6th Cir. 1974)

In this case a nonprofit psychiatric hospital created by physicians as successor to their for-profit institution purchased management services from the physicians, rented them office space, and provided them with equipment and clerical personnel at below fair market value rates. Held, the hospital was not operated exclusively for exempt purposes because a portion of its income inured to the physicians.

D. Hobby Clubs

St. Louis Science Fiction Limited v. Commissioner, T.C. Memo. 1985-162

This organization held an annual convention featuring art exhibits, readings, panel, discussions, and films on science fiction. It also held a masquerade party, a pool party, a sing-a-long, and provided a "huckster's room" selling science fiction books and memorabilia. The organization retained a 15% commission on art sales and rented space in the "huckster's room" to sellers at a flat rate. Held, the organization's activities were predominately social and recreational. The art auction and "huckster's room" provided substantial benefits to private interests.

9. Conclusion

Court decisions, private letter rulings, technical advice memoranda, G.C.M.'s, and articles in professional journals provide a continuing commentary on inurement and private benefit issues. All of these sources stress three major points: (1) an organization is exempt on the basis of its purposes and not its activities; (2) the issue as to what an organization's purposes are is to be resolved in light of the totality of the facts and circumstances in a particular case; and (3) the burden is generally upon the organization claiming exemption to establish that its operations are exclusively in furtherance of exempt purposes and that it does not operate for the benefit of private interests. Although new problems will arise in the context of inurement and private benefit, established principles and methods of analysis for dealing with these cases are available.

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1990 UPDATE
Editor's Note: In late 1990 the IRS updated each topic that came out in early 1990 in its Exempt Organizations Continuing Professional EducationTechnical Instruction Program textbook for 1990. As a result, what you have already read contains the topic as it was set forth in early 1990; what you are about to read is the 1990 update to that topic. We believe combining each text topic with its update will both improve and speed your research.

C. OVERVIEW OF INUREMENT/PRIVATE BENEFIT ISSUES IN IRC 501(c)(3)

1. Litigation Developments

A. Orange County Agricultural Society, Inc. v. Commissioner, 893 F. 2d 529 (2nd Cir. 1990)

The Second Circuit affirmed the Tax Court decision discussed on pages 57 - 58 of the text. The Tax Court relied on two theories in supporting revocation of the Society's 501(c)(3) exemption--substantial nonexempt purpose and inurement. The Circuit Court affirmed the opinion on both grounds.

The organization argued that its involvement in the automobile racing was substantially related to promoting the agricultural fair that constituted its exempt activity. The majority opinion conceded that some auto races, those immediately before, during, and after the fair, could be regarded as legitimate promotion. However, the auto racing occurred during at least six months of the year and the agricultural fair only lasted 12 days. Furthermore, there was no information in the record as to how the racing income was spread out among the various races held during the year. The record did show that only 3 or 4 of the 24 or 25 total races were held during the fair.

The Circuit Court held that

> the burden rested with [the] Taxpayer to show that a disproportionate share of the race and concession revenues were earned at the races held during the Fair, if this were in fact the case....After examining all of the evidence in the record, we affirm the Tax Court's finding that '[t]he Society's involvement in the automobile racing activity exceeded the benchmark of insubstantiality.' [Underlining supplied.]

B. Attila and Shigeko Rakosi v. Commissioner, unpublished opinion, (9th Cir. June 7, 1990), affirming T.C. Memo 1988-149

A husband and wife formed the Church of the Saved, took purported vows of poverty, and deposited the wife's salary from her job as a computer programmer in an account in the name of the church. The Rakosi's were the ministers of the church, which had no formal membership, no scheduled services, and no formal place for holding religious worship. The money in the church's account was used to pay the personal living expenses of the Rakosis.

The Tax Court concluded that the vow of poverty was ineffective to relieve Mrs. Rakosi of the obligation to pay federal income tax on her wages as a computer programmer. The Court also concluded that the Church of the Saved was not a church qualified to receive deductible charitable contributions. The Rakosis and the church appealed.

Mrs. Rakosi argued in the Tax Court that she had earned the wages as an agent of the church. The Circuit Court held that Mrs. Rakosi had presented no evidence that the church and her employer had entered into a contract for her services. Therefore, so far as that employer was concerned, she was not an agent of the church and her income earned from that employment was taxable to her.

Mrs. Rakosi argued that since the income had all been turned over to the church, she was entitled to a charitable contributions deduction. The Circuit Court pointed out that contributions to the church could be deducted only if none of the church's earnings inured to the benefit of any private individual. Since the Rakosis admitted that they used church money to support their personal living expenses, it was clear that the inurement proscription had been violated. Therefore, the Church was not described in section 170(c) and payments to it could not be deducted as charitable contributions.

The Circuit Court also upheld the imposition of penalties against the Rakosis for negligence and failure to file income tax returns. The Court brushed aside Mrs. Rakosi's argument that she had relied on her husband's advice in deciding not to file a tax return, stating that

> Shigeko was clearly negligent in assuming that she could avoid liability for federal income taxes and her obligation to file tax returns by turning her income over to the church and then continuing to spend the income for her support.

On this point the Court quoted approvingly from Hanson v. Commissioner, 696 F. 2d 1232, 1234 (9th Cir. 1983): "No reasonable person could put their faith in a flagrant tax avoidance scheme repeatedly rejected by the courts."

C. Kermit Fischer Foundation et al. v. Commissioner, T.C. Memo 1990-300

Otis W. Balis, Jr., was the sole trustee and foundation manager of a small private foundation with approximately$200,000 in assets. Balis served in this position without compensation for a number of years.

In 1981, 1982, and 1983 the Foundation paid Balis compensation of $33,700, $42,100, and $40,100, respectively. It purchased a computer for his use. The Foundation also purchased automobiles for his exclusive use in 1982 and 1983 and paid all costs of repairs, fuel, and maintenance on the automobiles. In 1982 and 1983 the Foundation rented an office for Balis' use.

The amounts paid to Balis as compensation ranged from $200 to $8,300 and were paid to him at irregular intervals ranging from 2 days to 2 weeks apart. The Foundation did not report Balis as an employee on its Forms 990-PF and did not file Forms 1099.

The Foundation's charitable contributions for 1982 and 1983 combined amounted to $1,725.

The Service revoked the Foundation's exempt status and asserted liability for excise taxes under sections 4940, 4941, and 4945. Balis and the Foundation resisted payment of the excise taxes.

At trial the Service introduced expert witness testimony that

> most foundations use a formula to determine annual compensation of their trustees of $4 to $5 per $1,000 of foundation assets, plus 5 percent of foundation income. Under this formula...the proper compensation for the foundation's trustee would range from $1,450 to $2,000 for each of the years at issue.

Based on this testimony, the Service contended that all compensation paid to Balis in excess of $2,000 per year was excessive and was subject to tax under sections 4941 and 4945.

Balis argued that his compensation was not unreasonable in light of the services he had rendered to the Foundation in prior years for no compensation at all. Further, the amounts received were comparable to the salary Balis had earned in other recent employment.

The Tax Court pointed out that the issues involved related to the particular years at issue and not some prior period. Further, Balis had offered no evidence to refute the Service's contention that reasonable compensation for his services during those years amounted to no more than $2,000 annually. The Court concluded that Balis had received excessive compensation and that he was liable for the excise tax imposed by section 4941 of the Code.

Payment of unreasonable administrative expenses, including excessive compensation, subjects a private foundation to liability for excise taxes under section 4945 unless the foundation used ordinary care and prudence in making a

good faith determination that the expenditures were reasonable. The Court concluded that

> Balis could not have been ignorant of the fact that his actions were rapidly draining the Foundation of its assets, and that the intended charitable beneficiaries of the Foundation were receiving only a small portion of its funds....We are not persuaded that Balis, on behalf of the Foundation, expended the above sums on automobiles, office space, and equipment for the good faith administration of the Foundation.

The Foundation was, therefore, liable for excise taxes under section 4945.