Exempt Organizations Technical Guide

TG 3-8: Disqualifying and Non-Exempt Activities, Inurement and Private Benefit - IRC Section 501(c)(3)

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I. Overview

(1) Organizations exempt under Section 501(c)(3) of the Internal Revenue Code (Code) must avoid engaging in impermissible conduct. Such conduct includes providing private benefit and inurement. An otherwise qualifying organization will be disqualified for exemption if it benefits private interests, either through inurement of its net earnings to certain "insiders," or by primarily benefiting the interests of persons who, though not "insiders," do not comprise a charitable class.

(2) Treasury Regulation (Treas. Reg.) 1.501(c)(3)-1(c)(2) states, "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 shareholders or individuals."

(3) This Technical Guide addresses the concepts of inurement and private benefit pertaining to Section 501(c)(3) organizations only.

A. Background

(1) Below is a brief history on the concepts of inurement and private benefit.

A.1. History of Inurement

(1) An organization recognized as exempt under Section 501(c)(3) is prohibited from permitting any of its net earnings to inure to the benefit of any private shareholder or individual.

(2) Historically, the prohibition on inurement was not contained in the original act that recognized certain corporations as exempt from federal income tax. See Tariff Act of 1894, Chapter 349, section 32, 28 Stat. 509, 556 (1894).

(3) The first reference to inurement originated in the Tariff Act of 1909. Except for rewording the term "net income" to "net earnings" by the Revenue Act of 1918, the concept regarding inurement and exempt organizations has not changed.

A.2. History of Private Benefit

(1) The private benefit standard doesn't derive its authority from the section of the statute prohibiting inurement of net earnings. Rather, it is based on the Section 501(c)(3) requirement that an organization be organized and operated exclusively for an exempt purpose. Private benefit is generally problematic for the operational test.

(2) Under the operational test, there are two factors to consider when determining if an organization is "operated exclusively" for exempt purposes under Treas. Reg. 1.501(c)(3)-1(c)(1):

a. 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).

b. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

(3) Treas. Reg. 1.501(c)(3)-1(d)(1)(ii) states, “An organization is not organized or operated exclusively for one or more of the purposes specified… [religious, charitable, scientific, testing for public safety, literary, educational or prevention of cruelty to children or animals] unless it serves a public rather than a private interest.”

(4) Therefore, under Section 501(c)(3), the activities of an organization must benefit the general public in a way that distinguishes it from a for-profit entity, which serves private interests (shareholders). Serving the public is a basic tenet of the law of charity; its purpose is to provide a public good. Treas. Reg. 1.501(c)(3)-1(d)(1)(ii) specifies that an organization must establish 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.

B. Inurement versus Private Benefit

(1) It’s important to differentiate between “inurement” and “private benefit.” The two terms are closely related and often mistakenly used interchangeably. However, they are two separate concepts, and not treating them as such can lead to incorrect conclusions. Since the enactment of Section 4958, Taxes on Excess Benefit Transactions, it’s even more crucial to know the differences between them.

a. The **first key** difference is that inurement applies to those who are “inside,” or in control of, the organization, whereas private benefit applies to a broader base. Private benefit encompasses those who are not only inside but also “outside” the organization. So, all inurement is private benefit, but not all private benefit is inurement.

b. The **second key** distinction is that inurement occurs when an insider (whether an individual or an entity) takes from the exempt organization's net earnings in some manner that benefits them. However, the private benefit doctrine focuses on the organization's primary activities. What are the activities? How broad is the class of persons they benefit? Does the class represent the community at large, or is there private benefit to certain individuals or entities? If private benefit exists, is it merely incidental?

c. The **third key** factor in comparing inurement and private benefit is the consequence of each. For inurement, any taking of net earnings is fatal to exemption. The quality of the organization's charitable activities is not relevant. By contrast, some private benefit may be permissible. If insubstantial, it may not be fatal to exemption.

(2)

Inurement	Private Benefit
Limited to insiders	Not limited to insiders
Can't benefit insiders	Can't substantially benefit private interests
Completely prohibited	Potentially permitted, if insubstantial

(3) For further analysis of inurement and private benefit, see:

a. American Campaign Academy v. C.I.R., 92 T.C. No. 66 (1989)

b. United Cancer Council, Inc. v. Comm'r, 165 F.3d 1173 (7th Cir. 1999)

C. Relevant Terms

(1) **Inurement:** 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 shareholders or individuals. See Treas. Reg. 1.501(c)(3)-1(c)(2).

(2) **Private Shareholder/Individual:** The words private shareholder or individual in Section 501 refer to persons having a personal and private interest in the activities of the organization. See Treas. Reg. 1.501(a)-1(c).

(3) **Private Benefit:** In general, an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. To meet these requirements, it is necessary for an organization to establish 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. See Treas. Reg. 1.501(c)(3)-1(d)(1)(ii).

(4) **Excess Benefit Transaction:** Any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. For these purposes, an economic benefit shall not be treated as consideration for the performance of services unless such organization clearly indicated its intent to so treat such benefit. See Section 4958(c)(1)(A).

D. Law/Authority

(1) Section 501(c)(3), Exemption from Tax on Corporations, Certain Trusts, and so forth: Provides, in part, for the exemption from Federal income tax to organizations organized and operated exclusively for charitable, religious, or

educational purposes, where no part of the net earnings inures to the benefit of any private shareholder or individual.

(2) Section 4958, Taxes on Excess Benefit Transactions: In general, Section 4958 imposes an excise tax on a disqualified person who engages in an excess benefit transaction with an applicable tax-exempt organization.

(3) Treas. Reg. 1.501(a)-1(c), Private Shareholder or Individual Defined: The words private shareholder or individual in Section 501 refer to persons having a personal and private interest in the activities of the organization.

(4) Treas. Reg. 1.501(c)(3)-(1)(a)(1), Organizational and Operational Tests: In order to be exempt as an organization described in Section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational or operational test, it is not exempt.

(5) Treas. Reg. 1.501(c)(3)-1(c)(2), Distributions 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 shareholders or individuals.

(6) Treas. Reg. 1.501(c)(3)-1(d)(1), Exempt Purposes: An organization may be exempt as an organization described in Section 501(c)(3) if it is organized and operated exclusively for one or more of the following purposes, religious, charitable, scientific, testing for public safety, literary, educational or prevention of cruelty to children or animals.

(7) Treas. Reg. 1.501(c)(3)-1(d)(1)(ii), Private Interests: An organization is not organized or operated exclusively for one or more of the purposes … unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interest such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

II. Inurement

(1) Section 501(c)(3) states that an exempt organization is organized and operated exclusively for charitable purposes only if no part of the net earnings inures to the benefit of any private shareholder or individual.

A. Inurement Defined

(1) Despite its strict prohibition, neither the Code nor the Treas. Regs. specifically define the term inurement. The Treas. Regs. give us a clearer understanding of the term “inure” as it relates to the prohibition:

a. Treas. Reg. 1.501(c)(3)-1(c)(2) states that an organization is not exclusively operated for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

b. Treas. Reg. 1.501(a)-1(c) defines a “private shareholder or individual” as “persons having a personal and private interest in the activities of an organization.”

(2) Simply put, inurement is the use of an exempt organization’s net earnings to benefit an insider. As a result, the organization does not exclusively serve the public.

B. Private Shareholder or Individual

(1) Treas. Reg. 1.501(a)-1(c) defines private shareholder or individual as “persons having a personal and private interest in the activities of the organization.” It places the focus of the inurement prohibition on those who, by virtue of a special relationship with the organization in question, are able to influence the use of its funds or assets.

(2) The following cases provide an analysis on private shareholders or individuals as it relates to inurement:

a. Church By Mail, Inc. v. Comm'r, 765 F.2d 1387 (9th Cir. 1985): The court found that the organization’s income inured to the benefit of its reverends and their families, who were private persons.

b. Est of Hawaii v. C.I.R., 71 T.C. 1067 (1979), aff'd in unpublished opinion 647 F.2d 170 (9th Cir. 1981): The courts found that the organization was set up to subsidize for-profit corporations.

(3) Individuals considered as having private interests include, but are not limited to:

a. Officers

b. Directors

c. Trustees

d. Board members

e. Members

f. Founders

g. Contributors

h. Key employees

i. Individuals with a close working relationship with the exempt organization

(4) These groups of individuals are generally referred to as insiders. The Code and Treas. Regs. do not contain language using the word “insiders” in the context of inurement. In United Cancer Council, Inc. v. Comm'r, 165 F.3d 1173 (7th Cir. 1999), the appeals court stated the inurement clause of Section 501(c)(3) interprets the phrase “private individual or shareholder” as an insider of the charity.

The court explained that the test for whether one is an insider is functional, and that it looks to the reality of control rather than to one's place in a formal table of organization. United Cancer Council at 1176.

(5) Section 501(c)(3) does not prohibit all dealings between a charitable organization and its founder or those in controlling positions. An organization's trustees, officers, members, founders, and contributors may, of course, receive reasonable compensation or fair market value for services or goods, or other expenditures in furtherance of exempt purposes.

(6) However, those in control may not, because of their position, acquire any of the charitable organization's funds. If funds are diverted from exempt purposes to private purposes, exemption is jeopardized.

(7) Dealings between a private foundation and certain closely related persons are restricted by Chapter 42 of the Code. These are discussed thoroughly in the Technical Guides on private foundations.

C. Insider Benefit

(1) The term "insider benefit," is not used or defined in the Code or Treas. Regs. It is, however, often used as a synonym for inurement.

a. The use of the term "insider" serves to distinguish inurement from the broader concept of private benefit.

b. The use of the term "benefit" highlights the broad interpretation placed on the Code language of "net earnings."

(2) The "net earnings" reference goes beyond a narrow accounting definition of net income to encompass almost any use, other than an arm's-length transaction or payment of reasonable compensation, of an organization's assets by an insider.

(3) When an exempt organization engages in a transaction with an insider, and there is a purpose to benefit the insider rather than the organization, inurement occurs. This is regardless of whether the transaction ultimately proves profitable for the exempt organization. The test is not whether there is profit or loss, but whether, at every stage of the transaction, those controlling the organization guarded its interests and dealt with related parties at arms-length.

D. Examples of Inurement

(1) Inurement may exist in many forms. Some examples are:

a. Unreasonable compensation

b. Payment of excessive rent

c. Detained or retained interests

d. Receipt of less than fair market values in sales or exchange property

e. Unsecured or inadequately secured loans

f. Prohibitive benefit from funds

g. Exempt organizations providing capital improvements to property owned by its insiders

h. Copyrights and royalties benefiting insiders

i. Interest free and/or unsecured loans to insiders

j. Dividends

D.1. Unreasonable Compensation

(1) Compensation arrangements can include a variety of benefits in addition to salary, such as welfare benefits, fringe benefits, and deferred compensation. Analyze the total compensation to determine if it is reasonable. In determining whether compensation is reasonable, consideration must be given to the individual's qualifications, duties, and hours.

(2) In Birmingham Bus. Coll., Inc. v. Comm'r, 276 F.2d 476 (5th Cir. 1960), the court held that those in control of an organization may not withdraw its earnings under the guise of salary payments.

(3) In Truth Tabernacle Church, Inc. v. C.I.R., T.C. Memo. 1989-451 (1989), the court reasoned that in determining whether compensation paid by an exempt organization is reasonable or excessive, one should apply the same criteria as under Section 162 (trade or business expenses). One factor to consider is whether comparable services would cost as much if obtained from an outside source in an arm's-length transaction.

(4) In Church of Living Tree v. C.I.R., T.C. Memo. 1996-291 (1996), the court upheld the IRS's determination that the organization was not operated exclusively for exempt purposes withing the meaning of Section 501(c)(3). The organization could not show that its objective to encourage the papermaking industry is a public and charitable purpose. Further, the organization could not show that its net income did not serve private purposes. The organization took over debts of the founder and provided him rent-free facilities although he received no compensation for his work with the organization.

(5) In John Marshall L. Sch. v. United States, No. 27-78, 1981 (Ct. Cl. 1981), the officers attempted to recharacterize inurement as reasonable compensation. The unaccredited schools were operated by family members and oversight and internal controls were weak. Officers received interest-free unsecured loans, noncompetitive scholarships for their dependents, nonbusiness travel expense reimbursements, and payments of personal expenses. The court, in upholding revocation, found such transactions constituted inurement.

(6) In Revenue Ruling (Rev. Rul.) 69-383, 1969-2 C.B. 113, the IRS provided an example of a reasonable compensation arrangement. A radiologist was compensated by a hospital per an agreement negotiated at arm's-length, and the IRS determined the radiologist was not in a position of control over the hospital. The amount received per the agreement was not excessive when

compared to amounts received by radiologists having similar responsibilities and handling comparable patient volume at similar hospitals.

D.2. Payment of Excessive Rent

(1) Often organizations will rent facilities, equipment, or other property from officers or directors of the organization. Rent can be paid at no more than fair market value for the property received. Excessive rent paid will result in the inurement of earnings to private individuals. See Texas Trade School v. C.I.R., 30 T.C. 642 (1959), aff'd, 272 F.2d 168 (5th Cir. 1959).

(2) In Rameses School of San Antonio, Texas v. C.I.R., T.C. Memo. 2007-85 (2007), the court stated, "for purposes of determining tax-exempt status, factors indicative of prohibited inurement and private benefit include:

a. Control by the founder over the entity's funds, assets, and disbursements

b. Use of entity moneys for personal expenses

c. Payment of salary or rent to the founder without any accompanying evidence or analysis of the reasonableness of the amounts, and

d. Purported loans to the founder showing a ready private source of credit."

D.3. Reversion of Retained Interests

(1) In Rev. Rul. 66-259, 1966-2 C.B. 214, a trust which provides for the reversion of principal on termination to the creator does not qualify for exemption under Section 501(c)(3).

(2) In Rev. Rul. 69-279, 1969-1 C.B. 152, an irrevocable inter vivos trust which provides that a fixed percentage of the income must be paid annually to the settlor, with the balance to charity, is not organized and operated exclusively for charitable purposes and is not exempt under Section 501(c)(3).

(3) In Rev. Rul. 69-176, 1969-1 C.B. 150, Situation 1, the organization accepted an income-producing asset in which the transferor has reserved a life interest. In accepting the asset, the organization acquired a remainder interest in the property, subject to a life interest reserved by the transferor. Only the remainder interest in the asset is dedicated to the organization's charitable purposes. Therefore, the transferor's receipt of the income does not constitute inurement of the organization's income to the benefit of private shareholders or individuals. Moreover, the organization is not operated for the benefit of private interests by reason of the payment of this income to the transferor. Such payment is merely the satisfaction of the transferor's reserved property right.

D.4. Benefit to Founders and Officers

(1) An organization exempt under Section 501(c)(3) must establish that it is not "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." See Treas. Reg. 1.501(c)(3)–1(d)(1)(ii).

(2) In Sonora Community Hosp. v. C.I.R., 46 T.C. 519 (1966), a hospital was operated to a substantial degree for the benefit of its founding doctors, who together with their associates were the source of 90% of the patients treated at the hospital, and who through private arrangements were the beneficiaries of one-third of the gross receipts of the X-ray department and clinical laboratory which the founders operated at the hospital. The amount of free care rendered was de minimis, being less than 1% of paid care. The court concluded that the organization was not operated for charitable purposes under Section 501(c)(3).

(3) In Lorain Ave. Clinic v. C.I.R., 31 T.C. 141 (1958), the court concluded that the organization was not operated for exempt purposes under Section 101(6) of the Code of 1934, the precursor to Section 501(c)(3). The organization's net earnings inured to the benefit of private individuals, and petitioner was not operated exclusively for charitable purposes. The organization was primarily operated for profit by a small family group, and any charitable services rendered by the associated physicians were occasional, and of too minor volume, to qualify petitioner for exemption.

(4) In Wendy L. Parker Rehabilitation Foundation, Inc. v. C.I.R., T.C. Memo. 1986-348 (1986), the court found inurement to exist and denied exemption to the applicant organization.

a. The organization was created to "aid the victims of coma, resulting from motor vehicular accidents, stroke, drowning, and other related causes; to provide such coma victims, who are in various stages of rehabilitation and recovery, with funds and therapeutic equipment and devices used in conjunction with accepted coma recovery programs; to run fundraising affairs and social functions in aid of coma victims; to exchange and disseminate information concerning the care and treatment of coma victims in all stages of recovery."

b. Wendy Parker was a coma victim. Her family maintained complete control over the organization. All of the officers were related to Wendy Parker. 30% of the organization's income was expended to benefit Wendy Parker.

c. The court stated "The distributions of funds for the benefit of Wendy Parker assist the Parker family in providing for her care. These funds will be used to pay for the medical and rehabilitative care of Wendy Parker. This relieves the Parker family of the economic burden of providing such care. Consequently, there is a prohibitive benefit from the petitioner's funds that inures to the benefit of private individuals."

D.5. Loans to Insiders

(1) In John Marshall L. Sch. v. United States, No. 27-78, 1981 (Ct. Cl. 1981), the court found inurement to exist when a family-controlled school provided interest-free unsecured loans to family member officers of the school. In

addition to the loans, family members received payments for non-business-related expenses, such as travel, entertainment, and health spa memberships. The court sustained the IRS's decision to revoke the school's exemption under Section 501(c)(3) for the years 1967-1973.

The school is now exempt under Section 501(c)(3)., effective January 28, 1993, due to the following factors:

a. The school has since expanded its board of trustees so that a majority of trustees are not related.

b. Family member compensation is now controlled by an independent board.

c. Also, the school's bylaws have been amended to provide that the trustees can no longer vote on their own compensation.

(2) In Lowry Hospital Association v. C.I.R., 66 T.C. 850 (1976), the court held that the hospital didn't qualify for exemption because its net earnings inured to the benefit of its founder and his other businesses. The loans weren't made on an arm's-length basis. They were made to an entity controlled by the founder, benefiting the founder.

(3) Conversely, in Griswold v. C. I. R., 39 T.C. 620 (1962), acq., 1965-2 C.B. 4 & 1965-2 C.B 5, the court ruled that the numerous loans made to insiders at current commercial rates, secured by adequate collateral, did not result in inurement.

(4) In Orange Cnty. Agr. Soc., Inc. v. Comm'r, 893 F.2d 529 (2d Cir. 1990), the court held that unpaid interest-free loans to officers constitutes inurement. The court stated, "the burden of proof is on the taxpayer to demonstrate that insiders do not benefit from the tax-exempt organization, especially where the facts indicate transactions arguably not on arm's-length terms."

III. Section 4958, Taxes on Excess Benefit Transactions

(1) Section 4958 imposes an excise tax on disqualified persons and organization managers who engage in an excess benefit transaction with an applicable tax-exempt organization.

(2) For a full discussion on this topic, see TG 65: Excise Taxes - Excess Benefit Transactions - IRC Section 4958.

A. Background and History

(1) Section 4958, Taxes on Excess Benefit Transactions, also referred to as Intermediate Sanctions, was added to the Code by Section 1311 of the Taxpayer Bill of Rights 2, P. L. 104-168 (110 Stat. 1452), enacted July 30, 1996. It generally applies to excess benefit transactions occurring on or after September 14, 1995. See P.L. 104-168, Section 1311(d)(1) and Treas. Reg. 53.4958-1(f)(1).

a. Prior to the enactment of Section 4958, the Code generally didn't provide for the imposition of excise taxes in cases where a Section 501(c)(3)

public charity or 501(c)(4) social welfare organization engaged in a transaction that resulted in inurement. In such cases, the only sanction specifically authorized under the Code was revocation of the organization's tax-exempt status.

b. P.L. 104-168 added intermediate sanctions (excise taxes on excess benefit transactions under Section 4958) that may be imposed when organizations described in section 501(c)(3) or 501(c)(4) engage in transactions with certain insiders that result in private inurement.

c. The intermediate sanctions for "excess benefit transactions" may be imposed by the IRS in lieu of (or in addition to) revocation of an organization's tax-exempt status. See H. Rep. No. 506, 104th Cong., 2d Sess. (1996) 53, 59.

d. In general, the intermediate sanctions are the sole sanction imposed in those cases where the excess benefit doesn't rise to a level that calls into question whether, overall, the organization functions as a charitable or other tax-exempt organization. In practice, revocation of tax-exempt status, with or without the imposition of excise taxes, would only occur when the organization no longer meets the substantive requirements for tax exemption under Section 501(c)(3).

(2) Notice 96-46, published September 23, 1996, summarizes Section 4958 enacted by P.L. 104-168 and specifies the tax form required to report and pay the excise tax.

(3) Treas. Regs. were published, effective January 23, 2002. They were partially amended by final regulations that were published in the Federal Register March 28, 2008, 73 F.R. 16519.

(4) Section 4958 was amended with regard to transactions involving donor-advised funds (DAFs) and supporting organizations under Sections 1232 and 1242 of the Pension Protection Act of 2006, P.L. 109–280 (120 Stat. 780), enacted August 17, 2006.

(5) Section 4958 was amended by Section 3 of the Tax Technical Corrections Act of 2007, P.L. 110-172 (121 Stat. 2473), enacted December 29, 2007. Sections 4958(c)(3)(A)(i)(II) and 4958(c)(3)(C)(ii) were amended to clarify the exclusions to disqualified persons in relation to the special rules for supporting organizations.

(6) Section 4958 was amended by Section 1322 of the Patient Protection and Affordable Care Act of 2010, P.L. 111-148, enacted March 23, 2010. In Section 4958(e)(1), the amendment added Section 501(c)(29) as an ATEO in addition to Sections 501(c)(3) & (4). Treas. Regs. have not been updated to reflect the changes of the Pension Protection Act and the Patient Protection and Affordable Care Act.

(7) See TG 65: Excise Tax – Excess Benefit Transaction – IRC Section 4958 for more information on excess benefit transactions and applicable excise taxes.

B. Excess Benefit Transaction

(1) Excess benefit transactions are any transactions where an economic benefit is provided by an applicable tax-exempt organization (ATEO) directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. See Section 4958(c)(1)(A).

B.1. Applicable Tax-Exempt Organization (ATEO)

(1) Per Section 4958(e), an ATEO is generally described as:

   a. A public charity under Section 501(c)(3)

   b. An organization described in Sections 501(c)(4) or 501(c)(29), or

   c. Any organization organized and operated under the preceding Sections at any time during the 5-year period ending on the date of the transaction

(2) A private foundation, as defined in section 509(a), is not an ATEO, and is not subject to excise tax under Section 4958.

(3) If you encounter a transaction involving a church, refer to Section 7611 procedures before proceeding. See Treas. Reg. 53.4958-8(b) and Treas. Reg. 301.7611-1, Question and Answer 19. See also IRM 4.70.19, Church Tax Inquiries and Examinations under IRC 7611.

B.2. Disqualified Persons

(1) A disqualified person, as defined in Section 4958(f)(1), includes:

   a. Any person who was, at any time during the 5-year period ending on the date of the transaction, in a position to exercise substantial influence over the affairs of the organization

   b. A member of the family of a disqualified person

   c. A 35% controlled entity, defined in Section 4958(f)(3)

   d. A person described in a, b, or c above of a related Section 509(a)(3) supporting organization to the ATEO

   e. A donor/donor advisor described in Section 4958(f)(7) involved in a transaction with a DAF

   f. An investment advisor defined in Section 4958(f)(8) with respect to a sponsoring organization of a DAF

   See Section 4958(f)(1) and Treas. Reg. 53.4958-3(a)(1).

(2) Per Section 4958(f)(4), family members are generally determined under Section 4946(d), with one exception. Section 4958 family members will include brothers and sisters (by whole or half-blood) of the individual and their spouses. Treas. Reg. 53.4958-3(b)(1) defines a disqualified person's family members as limited to the following:

a. Spouse

b. Brothers or sisters (by whole or half-blood)

c. Spouses of brothers or sisters (by whole or half-blood)

d. Ancestors

e. Children (including adoption) and their spouses

f. Grandchildren and their spouses

g. Great grandchildren and their spouses

B.3. Excise Tax Imposed

(1) Section 4958(a)(1) imposes a tax equal to 25% of the excess benefit on each excess benefit transaction between an ATEO and a disqualified person. The initial tax is sometimes referred to as the "First Tier Tax."

(2) If the 25% initial tax is imposed on an excess benefit with a disqualified person, Section 4958(a)(2) imposes a 10% tax, limited to $20,000 per transaction, on any organization manager who knowingly participated in the excess benefit transaction. The 10% tax won't be imposed if participation was not willful and due to reasonable cause. See Treas. Reg. 53.4958-1(d)(1).

(3) If the initial 25% tax is imposed on an excess benefit transaction between an ATEO and a disqualified person, and the excess benefit transaction isn't corrected within the taxable period, an additional excise tax equal to 200% of the excess benefit is imposed on the excess benefit transaction. See Section 4958(b) and Treas. Reg. 53.4958-1(c)(2)(i). The additional tax is sometimes referred to as the "Second Tier Tax."

(4) For an in-depth discussion of excise taxes on excess benefit transactions, see Technical Guide 65, Excise Taxes - Excess Benefit Transactions - IRC Section 4958.

IV. Private Benefit

(1) To be exempt from federal income tax under Section 501(c)(3) an organization must serve a public rather than a private interest. The organization must demonstrate that it is not organized or operated for the benefit of private interests. See Treas. Reg. 1.501(c)(3)-1(d)(1)(ii).

A. Private Benefit Defined

(1) The private benefit doctrine is derived from the requirement in Section 501(c)(3) that an organization be organized and operated exclusively for exempt purposes.

(2) Treas. Reg. 1.501(c)(3)-1(d)(1)(ii) states that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest.

To meet this requirement, “it is necessary for an organization to establish 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.”

(3) As discussed previously, inurement is one type of private benefit, but private benefit includes more than just inurement. Private benefit results when an individual benefits from the activities of a Section 501(c)(3) organization, regardless of the individual’s insider status.

(4) Although even a minimal amount of inurement results in the disqualification of an exempt organization, private benefit will not jeopardize tax-exempt status if it is incidental to the accomplishment of exempt purposes:

a. Private benefit can affect the exempt status of the organization if it is substantial.

b. Private benefit is part of the operational test and separate from the inurement doctrine because it is broader in scope.

(3) A charitable organization can give money, goods, or services to individuals without losing its exempt status. Many forms of charity involve aid to individuals. Help to poor people and to deserving students are traditional examples of charity. By contrast, private benefit involves gifts to individuals to serve their private purposes.

B. Private Benefit Restriction

(1) The private benefit restriction is not limited to benefits provided to insiders. Rather, the restriction applies to benefits provided to any individual, whether or not the individual is in a position to control or influence the organization. The private benefit restriction applies to all parties who receive a benefit not accorded to the public as a whole.

(2) Restrictions on membership, or other distinctions that restrict the class of persons served by an organization, can result in the organization primarily serving private interests. In Columbia Park and Recreation Ass'n., Inc. v. C.I.R., 88 T.C. No. 1 (1987), aff’d in unpublished opinion 838 F. 2d 465 (4th Cir. 1988), the court upheld denial of exemption under Section 501(c)(3) to an organization formed to develop and operate utilities, systems, services, and facilities “for the common good and social welfare” for a private real estate development with a population of over 100,000 residents. The development was neither an incorporated city nor other form of political subdivision. The court considered this fact significant in concluding that the organization was “…merely an aggregation of homeowners and tenants bound together in a structural unit formed as an integral part of a plan for the development of real estate.” As such, it lacked a “sufficient public element” to be a “community at large” in the charitable context.

C. Incidental Private Benefit

(1) If 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).

(2) To be incidental, the private benefit must be a necessary accompaniment of the activity which benefits the public at large and accomplishes exempt purposes. In other words, the benefit to the public cannot be achieved without necessarily benefiting certain private individuals.

   a. **Note:** The regulations use the term "substantial," rather than "incidental." The Code references "organized and operated exclusively," while the regulations interpret this as requiring no more than an insubstantial non-exempt purpose. Only in sub-regulatory guidance has the IRS interpreted incidental private benefit as being insubstantial.

(3) Further, private interests must be benefited only to the extent necessary to accomplish exempt purposes. It is a facts and circumstances test in that the public benefit from the organization's activities must outweigh any individual benefit. The key to understanding the concept of private benefit is understanding what "incidental" means in both a qualitative and a quantitative sense.

(4) In American Campaign Academy v. C.I.R., 92 T.C. 1053 (1989), a school that trained individuals to fill positions in political campaigns did not qualify for exemption under Section 501(c)(3). The court concluded that the organization's activities benefited the private interests of partisan entities and candidates more than incidentally, which constituted a substantial nonexempt purpose.

> Respondent contends that where the training of individuals is focused on furthering a particular targeted private interest, the conferred secondary benefit ceases to be incidental to the providing organization's exempt purposes. By contrast, respondent contends that when secondary benefits are broadly distributed, they become incidental to the organization's exempt purposes.
>
> Thus, while petitioner may incidentally benefit the public, we conclude that the administrative record and the partisan affiliation of the candidates served by petitioner's graduates in the 1986 election fully support respondent's determination that petitioner confers substantial private benefits on [redacted] entities and candidates.

(5) Rameses School of San Antonio, Texas v. C.I.R., T.C. Memo. 2007-85 (2007) states, "Upon a conclusion that relevant facts reveal private benefit, an organization will not qualify as operating primarily for exempt purposes 'absent a showing that no more than an insubstantial part of its activities further the private interests or any other nonexempt purposes.'"

(6) In Community Education Foundation v. C.I.R., T.C. Memo. 2016-223 (2016), the court stated, "In applying the operational test, 'exclusively' does not mean 'solely' or 'absolutely without exception'. Nonetheless, the presence of a single

nonexempt purpose, if substantial, precludes exempt status, regardless of the number or importance of truly exempt purposes."

(7) For additional guidance on this topic, see the following:

a. Rev. Rul. 70-186, 1970-1 C.B. 129 (1970): A nonprofit organization formed to preserve and improve a lake used extensively as a public recreational facility qualifies for exemption under Section 501(c)(3).

b. GCM 37789 (Dec. 18, 1978): A hospital which leases land adjacent to it to members of its staff and provides the staff with the financing to build a medical center on the land does not serve the private interests of the staff members other than incidentally.

c. GCM 38185 (Dec. 3, 1979): An organization which operates for the purpose of providing temporary housing, counseling, and transportation to individuals who have traveled to the organization's locality to visit and comfort friends and relatives who are patients in local health-care facilities qualifies for exemption under Section 501(c)(3). The GCM stated, "The element of private benefit in this case is clearly incidental, in both a qualitative and a quantitative sense, to the substantial overriding community benefit to be achieved from the visitation of patients in local health-care facilities."

d. GCM 38827 (Mar. 23, 1982): A communal religious organization may qualify for exemption under Section 501(c)(3). The GCM asserted, "While the private benefit must be incidental in both the qualitative and quantitative senses, the extent to which private benefit may be acceptable will vary, in each case, in direct relation to the degree of public benefit derived."

C.1. Qualitatively Incidental

(1) To be qualitatively incidental, private benefit must be a necessary by-product of the activity that benefits the public at large and accomplishes exempt purposes. In other words, the benefit to the public cannot be achieved without necessarily benefitting certain private individuals. For example, see Rev. Rul. 70-186, 1970-1 CB 128, where the organization's preservation of a lake as a public recreational facility was impossible to accomplish without providing a benefit to certain private property owners.

(2) In contrast, Rev. Rul. 75-286, 1975-2 C.B. 210, describes an organization formed by the residents of a city block to preserve and beautify that block, to improve all public facilities within the block, and to prevent physical deterioration of the block. Its activities consist of paying the city government to plant trees on public property within the block, organizing residents to pick up litter and refuse in the public streets and on public sidewalks within the block, and encouraging residents to take an active part in beautifying the block by placing shrubbery in public areas within the block. Membership in the organization is restricted to residents of the block and those owning property or operating businesses there.

The organization's support is derived from receipts from block parties and voluntary contributions from members. The revenue ruling concluded that the organization did not qualify for 501(c)(3) exemption because it operated to serve private interests by enhancing members' property rights as evidenced by its restricted membership and area served.

C.2. Quantitatively Incidental

(1) To be quantitatively incidental, private benefit must not be substantial relative to the public benefit. This is a facts and circumstances test that requires the public benefit from the organization's activities to outweigh any individual benefit. One example of quantitatively incidental private benefit may be found in Treas. Reg. 1.501(c)(3)-1(d)(1)(iii), example 2, in which the benefit to noncharitable beneficiaries was not quantitatively incidental.

(2) Private benefit was not quantitatively incidental in Rev. Rul. 76-152, 1976-1 C.B. 151. A group of art patrons formed an organization to promote understanding of modern art trends. The organization featured the artwork of local artists. If the artwork was sold, the gallery kept a 10% commission and paid the remainder of the money to the artists. In this ruling, private individuals who were not members of a charitable class received a substantial economic benefit. Because the benefit was not both qualitatively and quantitatively incidental, it was not considered insubstantial.

(3) In summary, unlike inurement, which is prohibited, private benefit will not preclude exemption under Section 501(c)(3) if the benefit is insubstantial. This means the private benefit is incidental, both qualitatively and quantitatively, relative to the organization's charitable purposes and activities.

D. Examples of Private Benefit

(1) The following are examples of private benefit as it relates to businesses, employees, members, and controlled organizations.

D.1. Private Benefit to Businesses

(1) Private benefit can result from grants, awards, scholarships, or research that creates substantial benefits for particular business interests.

(2) The IRS found private benefit to exist in the following scenarios (listed chronologically):

a. Rev. Rul. 65-1, 1965-1 C.B. 226: Researching new machinery for particular commercial operations

b. Rev. Rul. 68-373, 1968-2 C.B. 206: Testing drugs for commercial pharmaceutical companies

c. Rev. Rul. 69-632, 1969-2 C.B. 120: Developing new and improved uses for existing products of an industry

d. Rev. Rul. 71-505, 1971-2 C.B. 232: Promoting the practice of law by a city bar association

e. Rev. Rul. 74-553, 1974-2 C.B. 168: Operating medical peer review boards formed by a state medical association

f. Rev. Rul. 78-86, 1978-1 C.B. 151: Operating a facility that provides free parking for customers

g. Rev. Rul. 78-426, 1978-2 C.B. 175: Testing cargo containers

h. Rev. Rul. 80-287, 1980-2 C.B. 185: Operating a lawyer referral service

(3) An organization's activities that were aimed, in part, at promoting the prosperity and standing of the business community were determined to serve a substantial private purpose and, regardless of the number or importance of any of its other truly exempt purposes, will still fail to qualify for exemption under Section 501(c)(3). See Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945).

D.2. Private Benefit to Employees

(1) A tax-exempt organization may provide reasonable benefits to its employees; however, it cannot provide employee benefits as its primary purpose. An employee benefit organization funded and controlled by the employer may serve a business interest rather than an exclusively charitable purpose. Consider the following:

a. A foundation paid the educational and medical expenses of young performers employed by the founder, who was in show business. These expenditures were a form of compensation to the employees and directly furthered the business interests of the founder. See Horace Heidt Foundation v. United States, 170 F. Supp. 634 (Ct. Cl. 1959).

b. A trust created by an employer to pay pensions to retired employees relieves the employer of the burdens of the pension program. Also, payments to retired individuals are not, in themselves, charitable. See Rev. Rul. 56-138, 1956-1 C.B. 202.

c. A bequest to pay pensions to the retired employees of a corporation does not further charitable purposes when the group to whom the benefits are paid are not lacking the necessities or comforts of life. See Rev. Rul. 68-422, 1968-2 C.B. 207. See also, Watson v. United States, 355 F.2d 269 (3d Cir. 1965).

(2) In an employee benefit fund supported by the employees themselves where benefits are awarded in the event of death, illness, or disability, without regard to financial distress, the organization is a type of mutual benefit association, not a charity. This form of self-help serves the interests of the members, which is not a public purpose.

(3) A different result is possible where benefits to employees are not a form of indirect compensation and where benefits are awarded on truly charitable standards. In William B. Chase v. C.I.R, 19 T.C.M. 234 (1960), the court ruled that while the organization granted scholarships to children of the employees of related corporations, the awards were not a form of indirect compensation to the employees because the grants were based on clearly defined and objective criteria.

(4) A private foundation that grants scholarships to children of a particular employer should ensure that its program meets the requirements of Section 4945(d)(3) and (g). If not, it may be subject to penalties.

D.3. Private Benefit to Members

(1) Private benefit occurs when an organization's activities benefit members more than incidentally:

a. Rev. Rul. 67-367, 1967-2 C.B. 188: A subscription "scholarship" plan for individuals designated by the subscribers serves private rather than public purposes.

b. Rev. Rul. 69-175, 1969-1 C.B. 149: Bus transportation for members' children attending a private school serves a private rather than a public interest.

(2) Also, consider the following revenue rulings involving nurses' registers:

a. Rev. Rul. 61-170, 1961-2 C.B. 112: An employment register maintained primarily for the employment of members of a nurses' association promotes the interests of its individual members.

b. Rev. Rul. 55-656, 1955-2 C.B. 262: Conversely, a community nursing bureau, operated as a community project, to maintain a register of all qualified professional and paraprofessional personnel for the benefit of hospitals, health agencies, doctors, and members of the community, qualified for exemption under Section 501(c)(3).

(3) Private benefit was also addressed in these rulings involving navigable waterways:

a. In Benedict Ginsburg v. C.I.R., 46 T.C. 47 (1966), a nonprofit corporation, formed to dredge a navigable waterway fronting the properties of its members, received contributions solely from its members in proportion to the value of their properties. Evidence showed that the waterway was little used by the general public, but its navigability greatly affected the value of members' properties. It was formed for the private purposes of its members. Any objective to benefit the general public, if it existed at all, was a secondary one. The court held that the organization was not organized and operated exclusively for charitable purposes under Section 501(c)(3).

b. Conversely, in Rev. Rul. 70-186, 1970-1 C.B. 128, an organization, formed to preserve a lake as a public recreational facility and to improve the condition of the water in the lake, benefited the community as a whole. It was financed by lake-front property owners, by members of the community adjacent to the lake, and by municipalities bordering the lake. The private benefit was incidental. As such, the organization qualified for exemption under Section 501(c)(3).

(4) Private benefit takes many forms. In Syrang Aero Club V. C.I.R., 73 T.C. 717 (1980), an organization served as a recruitment incentive for and provided aerial assistance to the Syracuse Air National Guard. It owned an airplane which it rented at low cost to its members. Its membership was restricted to members of the Syracuse Air National Guard and civilian employees, active and retired members of reserve military units, and personnel of the Federal Aviation Agency. The organization provided no classes or instructional materials and employed no faculty. The court held that the organization did not qualify for exemption under Section 501(c)(3). It was organized and operated for a substantial non-exempt purpose; specifically, providing recreational opportunities to members. It only incidentally served an educational or charitable purpose.

D.4. Permissible Benefits - Controlled Organizations

(1) Tax advantages, or other incidental benefits, to an individual or entity from transactions with a controlled exempt organization do not necessarily result in private benefit or inurement.

(2) Rev. Rul. 69-39, 1969-1 C.B. 148: A charity purchased securities from its creator for less than fair market value. The creator claimed a charitable contribution equal to the difference between the fair market value of the securities and the price at which they were sold to the charity. Although the transaction may have resulted in an advantage to the creator, the charity profited from the transaction and its exemption was not affected. See William Waller, et at. v. C.I.R., 39 T.C. 665 (1963), acq., 1963-2 C.B. 3.

(3) Rev. Rul. 66-358, 1966-2 C.B. 218: Where a business corporation donated lands and money to a foundation to establish a public park, exemption was not jeopardized by the donor’s retention of the right to use as a brand symbol a scenic view located in the park.

(4) Rev. Rul. 77-367, 1977-2 C.B. 193: A corporation created an organization to operate a replica of an early 19th century American village named after the corporation. The corporation donated the land upon which the village was located and provided a substantial amount of financial support. Although the corporation benefits by having its name mentioned in conjunction with the organization’s advertising program, such benefits are merely incidental to benefits flowing to the general public from access to the village and its historic structures.

(5) Rev. Rul. 72-559, 1972-2 C.B. 247: An organization subsidized recent law graduates who provided free legal services to low-income residents of economically depressed communities. Any private benefit derived by the legal interns is incidental to the public charitable purpose.

V. Examination Techniques

(1) The following section provides tips and techniques to identify inurement and private benefit while reviewing exemption applications and returns filed by exempt organizations.

A. Inurement

(1) When reviewing Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Code, the specialist should consider the following to determine if inurement is present:

a. How will the organization achieve its exempt purpose? What activities will it conduct and how will it conduct them?

b. Who benefits from the activities?

c. Who controls the organization? Who are the insiders?

d. Who is compensated? Based on the information provided, was the compensation negotiated at arm's-length? Is it reasonable?

e. Will compensation be paid to insiders? Does the organization's board have broad representation from the community it serves? Or is the board dominated by one or two individuals or families?

f. Were all written agreements or contracts negotiated at arm's-length? Review the terms of the agreements/contracts.

g. How are funds being used? Review the expenses.

h. Is the organization authorized to pay dividends to stockholders? Review the organizing documents and bylaws.

(2) Review Form 990, Return of Organization Exempt From Income Tax, and Form 990-EZ, Short Form Return of Organization Exempt From Income Tax, for indicators of inurement.

a. Identify the activities of the organization, as well as any substantial changes.

b. Review the checklist of required schedules. If the organization answered "Yes" to any of the questions, review the corresponding schedule.

c. Review Schedule L, Transactions with Interested Persons, for information on excess benefit transactions. Identify the transactions and the related parties.

d. Review Schedule R, Related Organizations and Unrelated Partnerships. This schedule provides information on the identification of disregarded

entities, related tax-exempt organizations, related taxable partnerships, related taxable corporations or trusts, transactions with related organizations, and unrelated organizations taxable as a partnership.

e. Review Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees, and Independent Contractors to identify the insiders of the organization. This should be reviewed in conjunction with Schedule J, Compensation.

(3) Review salaries paid to those controlling the organization and to other key employees. To determine if they are reasonable, consider factors such as:

a. Duties performed

b. Amount and type of responsibility

c. Time devoted to duties

d. Special knowledge and experience

e. Individual ability

f. Previous training

g. Compensation paid in prior years

h. Prevailing economic conditions

i. Living conditions of the particular locality

j. The type of activities carried out by the organization and its size

(4) Reconcile salaries the organization paid to wages on Forms W-2, Wage and Tax Statement of the employees.

a. What was included in taxable income?

(5) Request copies of employment contracts or compensation packages as deemed pertinent.

a. Check the date and the specific compensation the organization intended to pay.

(6) Review disbursements.

a. Look for exempt organization payment of expenses to or for the benefit of an officer or employee that isn’t reported as wages on Forms W-2.

(7) Consider the status of the recipients to determine who meets the various criteria of an insider, an outsider, or a disqualified person with respect to the organization.

(8) Review other compensation amounts, including fringe benefits. Determine if the compensation is excludable from the recipient's gross income under Section 132 or includible under Section 61.

a. Look closely at reimbursements such as travel expenses. Were payments made under a non-accountable plan?

b. If so, determine if the amounts paid meet the ordinary and necessary requirements of Section 162. Was the amount included on Forms W-2?

(9) Determine if there were any sales or exchanges of property.

a. If so, were there any insiders, disqualified persons, foundation managers involved? Was the sale or exchange at fair market value?

(10) Analyze the composition of the organization's assets.

a. Did an insider, disqualified person, or foundation manager have personal use of any assets?

b. For example, did any of them use a vehicle for both personal and business travel?

c. If used for personal use, was an amount included on the Forms W-2?

(11) Analyze fundraising agreements to determine if they are at arm's-length.

a. Consider the method of raising funds and whether this income is subject to unrelated business tax.

b. Does the fundraiser exercise control over the organization in any way?

(12) Determine if there are entities related to the exempt organization.

a. Analyze the structure of any transactions between the related entities and the exempt organization.

b. Are the transactions:

- At arm's-length?
- At fair market value?
- Exclusive?

B. Private Benefit

(1) When reviewing Form 1023, the specialist should consider the following to determine if private benefit is present:

a. Who benefits from the organization’s activities? Is the benefit for the general public, or is it for private interests? How much benefit is given? Is it substantial or insubstantial? Is the benefit limited to a particular group or geographic area? Are benefits to private persons necessary to achieve the organization’s exempt purpose?

b. Review the organizing documents to identify the organization’s exempt purpose and determine who benefits from its activities.

c. Review the bylaws to analyze the organizational structure. If the organization has members, does it have different classes of members? If yes, do their benefits differ?

(2) Review Form 990 and Form 990-EZ for indicators of private benefit:

a. Identify the activities of the organization, as well as any substantial changes.

b. Review the checklist of required schedules. If the organization answered "Yes" to any of the questions, review the corresponding schedule.

(3) To determine when a private individual's benefit outweighs the benefit to the general public, consider asking the following questions during your interview and review of the books and records:

a. What is the organization's primary purpose and activities?

b. What is the nature of the benefit?

c. Who receives it?

d. What is the amount of the benefit?

e. How large is the class of individuals receiving the benefit?

f. Does an individual's private benefit result in significant public benefit?

g. Does the private individual's benefit outweigh society's benefit?

C. Plan of Action

(1) The lead sheets and work papers should be properly completed:

a. Reflect the conclusion

b. List the audit steps taken

c. Correctly document the facts

d. Cite the proper Code section and regulations relating to the issue.

(2) All supporting documents on the issue should be footed with the proper reference number and should be referenced during the narrative.

(3) All supporting documentation for any given issue needs to be referenced and placed behind the main lead sheet. This allows a reviewer to follow the audit steps to determine how you reached your conclusion.

D. Digest of Precedent Rulings

(1) The following is a list of revenue rulings and case law that illustrate issues related to inurement and private benefit.

a. The revenue rulings are listed in chronological order, with key words identifying the organizations' primary activities. Short summaries of the rulings, with the IRS' conclusions, are also provided.

b. The court cases are listed in alphabetical order, with short summaries of the opinions.

D.1. Revenue Rulings

(1) Rev. Rul. 55-656, 1955-2 C.B. 262: *Nurses' registers* – A nonprofit community nursing bureau that maintains a register of qualified nursing personnel, including graduate nurses, unregistered nursing school graduates, licensed attendants, and practical nurses, for the benefit of hospitals, health agencies, doctors and individuals, as a community project, qualifies for Section 501(c)(3) exemption. It receives financial support from community organizations and public contributions.

(2) Rev. Rul. 56-138, 1956-1 C.B. 202: *Employee benefits* – A trust organized to pay pensions to retired employees is not exempt under Section 501(c)(3).

(3) Rev. Rul. 61-170, 1961-2 C.B. 112: *Nurses' register* – A nurses' association that maintains an employment registry primarily for the employment of members is not entitled to Section 501(c)(3) exemption.

(4) Rev. Rul. 65-1, 1965-1 C.B. 226: *Research and development* – An organization that makes research grants for the development of new machinery to be used in particular commercial operations and retains all the rights to the new developments does not qualify for exemption under Section 501(c)(3).

(5) Rev. Rul. 66-104, 1966-1 C.B. 135: *Business benefits* – A nonprofit organization that makes funds available to authors and editors for preparing teaching materials and writing textbooks, and under the terms of the contract with the publisher receives royalties from the sales of published materials and then shares them with those individuals, does not qualify for exemption under Section 501(c)(3).

(6) Rev. Rul. 66-259, 1966-2 C.B. 214: *Reversionary interest in a trust* – A trust that provides for the reversion of principal on termination to the creator does not qualify for exemption under Section 501(c)(3).

(7) Rev. Rul. 66-358, 1966-2 C.B. 218: *Public park* – Where a business corporation donated lands and money to a foundation to establish a public park, exemption under Section 501(c)(3) was not jeopardized by the donor's retention of the right to use as a brand symbol a scenic view located in the park.

(8) Rev. Rul. 67-5, 1967-1 C.B. 123: *Investments benefiting insiders in a family-controlled foundation* – A foundation, controlled by the creator's family and operated to enable the creator and his family to engage in financial activities beneficial to them, results in the foundation's ownership of non-income-producing assets, which then prevents it from carrying on a charitable program commensurate in scope with its financial resources. It is not entitled to exemption.

(9) Rev. Rul. 67-149, 1967-1 C.B. 133: *Financial support of other organizations* – An organization provides financial assistance to exempt organizations by

distributing funds at periodic intervals. It carries on no operations other than to receive contributions and incidental investment income, not accumulated. It is exempt from tax.

(10) Rev. Rul. 67-367, 1967-2 C.B. 188: *Scholarships for pre-selected individuals* – An organization whose sole activity is the operation of a "scholarship fund" plan that makes payments to pre-selected, specifically named individuals, does not qualify for exemption.

(11) Rev. Rul. 68-373, 1968-2 C.B. 206: *Commercial drug testing* – A nonprofit organization primarily engaged in testing drugs for commercial pharmaceutical companies does not qualify for exemption under Section 501(c)(3).

(12) Rev. Rul. 68-422, 1968-2 C.B. 207 and Rev. Rul. 56-138, 1956-1 C.B. 202: *Pension plan* – An organization created pursuant to the will of a stockholder of a company to pay pensions to all retired employees of that company does not qualify for exemption under Section 501(c)(3).

(13) Rev. Rul. 68-489, 1968-2 C.B. 210: *Financial support of other organization* – An organization will not jeopardize its exemption even though it distributes funds to non-exempt organizations, provided it retains control and discretion over use of the funds for Section 501(c)(3) purposes.

(14) Rev. Rul. 69-39, 1969-1 C.B. 148: *Permissible benefits* – A charitable organization's exemption from tax will not be affected by purchasing securities from its creator (and sole trustee) at the price he paid, at or below fair market value, and reselling them at a profit.

(15) Rev. Rul. 69-175, 1969-1 C.B. 149: *School bus transportation* – A nonprofit organization formed by parents of pupils attending a private school that provides school bus transportation for its members' children serves a private rather than a public interest.

(16) Rev. Rul. 69-176, 1969-1 C.B. 150: *Deferred or retained interests* – The exempt status of an organization is not affected by the acceptance of an income-producing asset subject to a reserved life estate in the transferor or in exchange for an annuity specifically charged against the asset.

(17) Rev. Rul. 69-256, 1969-1 C.B. 150: *Perpetual care of burial lot* – A testamentary trust established to make annual payments to exempt charitable organizations and to use a fixed sum from annual income for the perpetual care of the testator's burial lot is not exempt under Section 501(c)(3).

(18) Rev. Rul. 69-266, 1969-1 C.B. 151: *Medical research* – An organization, formed and controlled by a medical doctor to conduct research programs consisting of examining and treating patients who are charged the prevailing fees for services rendered, is not exempt under Section 501(c)(3).

(19) Rev. Rul. 69-279, 1969-1 C.B. 152: *Trust beneficiary payments* – An irrevocable inter vivos trust which provides that a fixed percentage of income must be paid annually to the settlor with the balance to charity is organized and

operated for private interests because part of the net earnings inures to the benefit of the disqualified person.

(20) Rev. Rul. 69-383, 1969-2 C.B. 113 and Rev. Rul. 69-545, 1969-2 C.B. 117: *Compensation arrangement* – The exempt status of a hospital under Section 501(c)(3) will not be jeopardized where, after arm's-length negotiations, it enters into a revenue-sharing arrangement with a hospital-based specialist for compensation on the basis of a fixed percentage of the departmental income, and the compensation is not excessive when compared to the amounts received by specialists with similar responsibilities and handling a comparable patient volume.

(21) Rev. Rul. 69-632, 1969-2 C.B. 120: *New uses for an industry's products* – A nonprofit organization composed of members of a particular industry to develop a new and improved use for existing products of the industry is not exempt under Section 501(c)(3) but may qualify under Section 501(c)(6).

(22) Rev. Rul. 70-186, 1970-1 C.B. 128: *Lake maintenance* – A nonprofit organization formed to preserve and improve a lake used extensively as a public recreational facility qualifies for exemption under Section 501(c)(3) because any benefit derived by the lake-front property owners was incidental. It would be impossible for the organization to accomplish its purposes without providing benefits to the lake front property owners.

(23) Rev. Rul. 70-533, 1970-2 C.B. 112: *Day care center* – A children's day care center that is primarily funded by federal grants and is not restricted to children of employees of the sponsoring employer, but instead is open to members of the community and selects children on the basis of financial need and children's needs, is exempt under Section 501(c)(3).

(24) Rev. Rul. 71-395, 1971-2 C.B. 228, clarified by Rev. Rul. 76-152, 1976-1 C.B. 151: *Cooperative art gallery* – A cooperative art gallery formed and operated by a group of artists for the purpose of exhibiting and selling their works does not qualify for exemption under Section 501(c)(3) because the private benefit is not quantitatively incidental. Private individuals who were not members of a charitable class received a substantial economic benefit.

(25) Rev. Rul. 71-505, 1971-2 C.B. 232: *City bar association* – A city bar association exempt under Section 501(c)(6) that primarily directs its activities to the promotion and protection of the practice of law may not be reclassified as an educational or charitable organization under Section 501(c)(3).

(26) Rev. Rul. 72-147, 1972-1 C.B. 147: *Low-income housing* – An organization formed to provide low-income housing to families but giving preference for housing to employees of a farm proprietorship operated by the individual who created and controls the organization does not qualify for exemption under Section 501(c)(3).

(27) Rev. Rul. 72-559, 1972-2 C.B. 247 and Rev. Rul. 78-310, 1978-2 C.B. 173: *Legal aid* – An organization formed to provide legal services for low-income

residents of economically depressed communities is exempt as a charitable organization under Section 501(c)(3).

(28) Rev. Rul. 74-553, 1974-2 C.B. 168: *Medical peer review board* – A nonprofit organization formed by members of a state medical association to operate medical peer review boards is primarily furthering the common business interests of members and exempt under Section 501(c)(6) but not exempt under Section 501(c)(3). See also Rev. Rul. 73-567, 1973-2 C.B. 178.

(29) Rev. Rul. 75-196, 1975-1 C.B. 155: *Law library* – An organization operating a law library whose rules limit use to members of a local bar association composed of substantially all of the members of the legal profession in the municipality qualifies for exemption under Section 501(c)(3).

(30) Rev. Rul. 76–91, 1976 –1 C.B. 149: *Purchase of assets by related organization* – The purchase, in a transaction not at arm's-length, of all the assets of a profit-making hospital by a nonprofit hospital corporation at a price that includes the value of intangible assets, determined by the capitalization of excess earnings formula by an independent appraiser, does not result in the inurement of the hospital's net earnings to the benefit of any private shareholder or individual or serve a private interest precluding exemption.

(31) Rev. Rul. 76-441, 1976–2 C.B. 147: *For-profit school converted to nonprofit school* – The Ruling compares two disparate instances of conversions. Situation 1: An organization that purchases or leases at fair market value the assets of a former for-profit school and employs the former owners, who are unrelated to the current directors, at salaries commensurate with their responsibilities, is operated exclusively for educational and charitable purposes. Situation 2: An organization that takes over a school's assets and its liabilities, which exceed the value of the assets and include notes owed to the former owners and current directors of the school, is serving the directors' private interests and is not operated exclusively for educational and charitable purposes.

(32) Rev. Rul. 78-426, 1978–2 C.B. 175: *Testing cargo containers* – An organization that inspects and certifies the safety of cargo shipping containers is not operated exclusively for the purposes of testing for public safety or for scientific purposes. Also, see Rev. Rul. 65-61, 1965-1 C.B. 234 distinguished.

D.2. Case Law

(1) American Campaign Academy v. C.I.R., 92 T.C. 1053 (1989): The court distinguished between inurement and private benefit in denying declaratory judgment to a school that trained individuals to fill positions in political campaigns. The IRS contended the entity didn't meet the operational test for Section 501(c)(3) because it engaged in activities that served private interests versus a public purpose. The court also rejected the petitioner's argument that because the inurement prohibition is limited to insiders, benefits to third parties couldn't violate the private benefit doctrine. The court stated, "secondary

benefits which advance a substantial purpose cannot be construed as incidental to the organization's exempt educational purpose."

(2) Anclote Psychiatric Center, Inc. v. C.I.R., T.C. Memo. 1998-273 (1998): An exempt psychiatric hospital's officers and directors sought to convert the organization to a for-profit and sell it to an entity the board created. The question before the court was whether the sale price was close enough to fair market value to conclude there was no inurement. The court ruled that tax-exempt status was properly revoked based on inurement.

(3) Basic Bible Church v. C.I.R., 74 T.C. 846 (1980): The organization's founder and his wife executed vows of poverty and transferred all their possessions and income to the organization on the condition that it qualified under Section 501(c)(3). The founder controlled all financial decisions of the organization. The court found that a substantial purpose of the organization was to serve the private interests of the founder and his wife. Over 96% of the contributions the organization received (mostly from the founder and his wife) were spent on the founder's and his wife's subsistence, their unsubstantiated travel, and upkeep and utilities of their home, which was labeled their "parsonage." Less than 1% of contributions were spent for direct church related expenses. Accordingly, the court held that the organization did not qualify under Section 501(c)(3).

(4) Housing Pioneers, Inc. v. Commissioner, 58 F.3d 401 (9th Cir. 1995): The organization's purpose was to provide affordable housing for low income and handicapped persons. The court ruled that even though the tax reductions were to be used exclusively to make rents affordable, inurement was present. Federal income tax advantages and property tax reductions resulted in inurement at least indirectly to the benefit of the non-exempt partners (two of whom were insiders with respect to the exempt entity) because their partnerships were relieved of maintaining rents at a level sufficient to cover operating expenses that would otherwise have to be paid out of partnership capital.

(5) Hutterische Bruder Gemeinde v. C.I.R., 1 B.T.A. 1208 (1925): The court found certain corporations did not qualify for exempt status since they were not operated exclusively for religious (charitable) purposes. Rather, they operated for the benefit of their members, which did not serve a religious (charitable) purpose.

(6) Retired Teachers Legal Defense Fund, Inc. v. C.I.R., 78 T.C. 280 (1982): An organization was formed for 25,000 members to protect a teachers' retirement system's financial stability by ensuring purchase of only certain bonds at prices no higher than market price and restoration of any losses incurred. The court denied exempt status in part because the entity failed the operational test based on presence of substantial private benefit. The 25,000 members were not a large enough class to constitute the "public."

(7) Wendy L. Parker Rehabilitation Foundation, Inc. v. C.I.R., T.C. Memo. 1986-348 (1986): The court found inurement to exist and denied exemption to the

applicant organization. The distributions of funds for the benefit of Wendy Parker assist the Parker family in providing for her care. These funds will be used to pay for the medical and rehabilitative care of Wendy Parker. This relieves the Parker family of the economic burden of providing such care. Consequently, there is a prohibitive benefit from the petitioner's funds that inures to the benefit of private individuals.