

H. PRIVATE BENEFIT UNDER IRC 501(c)(3)

by

Andrew Megosh, Lary Scollick, Mary Jo Salins and Cheryl Chasin

1. Introduction

This article discusses the concept of "private benefit" under IRC 501(c)(3) and then describes how it applies to specific fact patterns that raise private benefit issues in two areas: housing and charter schools. Several prior CPE articles have discussed the concepts of private benefit and inurement in greater detail. The most comprehensive of these is Topic C in the 1990 CPE text, *Overview of Inurement/Private Benefit Issues in IRC 501(c)(3)*.

2. Private Benefit – Code and Regulations

IRC 501(c)(3) explicitly prohibits inurement, but does not mention "private benefit." However, the statute does provide that an entity be "organized and operated exclusively for religious, charitable, scientific" and other specified purposes. Reg. 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as operated exclusively for exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Reg. 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. Thus, even if an organization has many activities which further exempt purposes, exemption may be precluded if it serves a private interest. Applying the Supreme Court rationale in Better Business Bureau Of Washington, D. C., Inc. v. United States, 326 U.S. 279 (1945), the presence of private benefit, if substantial in nature, will destroy the exemption regardless of an organization's other charitable purposes or activities.

Inurement and private benefit have often been confused. The inurement prohibition comes from the section 501(c)(3) statutory language "... no part of the net earnings of which inures to the benefit of any private shareholder or individual...." There is general agreement that inurement is a subset of private benefit and involves unjust payment of money. For purposes of this article, we are focusing on the broader concept of private benefit, especially as it must be addressed and judged by the determination specialist in processing Form 1023 applications for section 501(c)(3) exemption.

3. Private Benefit and the Application Process

Whether an organization's activities will serve private interests excessively is a factual determination. In reviewing an application for exemption under IRC 501(c)(3), a determination specialist must exercise judgment in determining whether the facts show

that the applicant serves public rather than private interests. Information must exist in the file that clearly shows the organization has met the requirement. This may require further factual development, especially if the applicant will be controlled by a relatively small group or the class served by the organization is narrowly drawn. If an organization is closely controlled, either by a board of directors comprised of related persons or a for-profit management company that operates with a great amount of autonomy, the application file must clearly show the organization meets the requirements of Reg. 1.501(c)(3)-1(d)(1)(ii) that it has established that it is not or will not be organized or operated for the benefit of private interests. Although factors such as close control of the applicant, a proposed purchase from, financial transaction with, or management agreement with persons in control or related parties do not necessarily preclude exemption, they require adequate documentation and analysis to establish that the applicant operates for public rather than private purposes.

In Bubbling Well Church of Universal Love, Inc. v. Commissioner, 74 T.C. 531 (1980) aff'd, 670 F.2d 104 (9th Cir. 1980), the Tax Court considered the qualification for exemption of an organization purporting to be a church. The applicant was controlled by three family members. The court stated:

While this domination of petitioner by the three Harberts, alone may not necessarily disqualify it for exemption, it provides an obvious opportunity for abuse of the claimed tax-exempt status. It calls for open and candid disclosure of all facts bearing upon petitioner's organization, operations, and finances so that the Court, should it uphold the claimed exemption, can be assured that it is not sanctioning an abuse of the revenue laws. If such disclosure is not made, the logical inference is that the facts, if disclosed, would show that petitioner fails to meet the requirements of section 501(c)(3).

Thus, close control of an applicant, because of the potential for abuse, requires a clear demonstration that private interests will not be served

4. Private Benefit -- Defined

The Tax Court, in American Campaign Academy v. Commissioner, 92 TC 1053 (1989), has provided a useful definition of private benefit: "nonincidental benefits conferred on disinterested persons that serve private interests." We will consider each part of this definition in turn.

A. Nonincidental

Genuine public benefit often provides an incidental benefit to private individuals. But if private interests are served *other than incidentally*, exemption is precluded. GCM

37789 helps define incidental by explaining that private benefit must be both qualitatively and quantitatively incidental.

Qualitatively incidental means that the private benefit is a mere byproduct of the public benefit. A good example is Rev. Rul. 70-186, 1970-1 C.B. 128, in which an organization was formed to preserve and enhance a lake as a public recreational facility by treating the water. The lake is large, bordering on several municipalities. The public uses it extensively for recreation. Along its shores are public beaches, launching ramps, and other public facilities. The organization is financed by contributions from lake front property owners, members of the adjacent community, and municipalities bordering the lake. The revenue ruling concluded the benefits from the organization's activities flow principally to the general public through well maintained and improved 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.

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.

For private benefit to be *quantitatively* incidental, it must be insubstantial in amount. The private benefit must be compared to the public benefit of the specific activity in question, not the public benefit provided by all the organization's activities. The more exactly you can quantify the private benefit, the more likely it is to be non-incidental. You should also consider the number of entities benefiting. That is, if all of an organization's business dealings are with a single entity (or group of related entities), or promoter or developer, private benefit is more likely to be present. Further, private benefit is more likely to be substantial if the group receiving the benefit is small.

B. Benefits

Unlike inurement, private benefit does not necessarily involve the flow of funds from an exempt organization to a private party. Rev. Rul. 76-206, 1976-1 C.B. 154, considered an organization formed to promote broadcasting of classical music in a particular community. The organization carried on a variety of activities designed to stimulate public interest in the classical music programs of a for-profit radio station, and thereby enable the station to continue broadcasting such music. The activities included soliciting sponsors, soliciting subscriptions to the station's program guide, and distributing pamphlets and bumper stickers encouraging people to listen to the station. The organization's board of directors represented the community at large and did not include any representatives of the for-profit radio station. The revenue ruling concludes that the organization's activities enable the radio station to increase its total revenues and therefore benefit the for-profit radio station in more than an incidental way. Therefore, the organization is serving a private rather than a public interest and does not qualify for exemption.

Rev. Rul. 76-206 demonstrates several important ideas about private benefit. There was no control by the for-profit radio station. There was no direct flow of funds from the applicant to the for-profit. However, it provided services that the radio station would have otherwise had to purchase. As far as can be determined from the ruling, the motivation of the organization's creators was purely a desire to continue the broadcasting of classical music in their community. Although the organization's broad purpose of promoting interest in classical music and encouraging programming of classical music provides a public benefit, the activities served the private economic interests of the for-profit radio station to a substantial degree. Therefore, because private interests were served, exemption was precluded.

Also unlike inurement, finding private benefit does not require that payments for goods or services be unreasonable or exceed fair market value. For example, in est of Hawaii v. Commissioner, 71 T.C. 1067 (1979), the Tax Court stated:

Nor can we agree with petitioner that the critical inquiry is whether the payments made to International were reasonable or excessive. Regardless of whether the payments made by petitioner to International were excessive, International and EST, Inc., benefited substantially from the operation of petitioner.

Similarly, in Church by Mail v. Commissioner, 765 F. 2d 1387 (9th Cir. 1985), aff'g TCM 1984-349 (1984), the Tax Court found it unnecessary to consider the reasonableness of payments made by the applicant to a business owned by its officers. The 9th Circuit Court of Appeals, in affirming the Tax Court's decision, stated:

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

C. Disinterested Persons

Inurement involves benefit to insiders such as officers or directors. Private benefit, on the other hand, can involve benefits to anyone other than the intended recipients of the benefits conferred by the organization's exempt activities. These intended recipients would be the poor, sick, elderly, students, the general public, or other group constituting a charitable class. Disinterested persons can include insiders as well as related or unrelated third-parties, such as the radio station in Rev. Rul. 76-206, the business owned by the officers in Church by Mail, the travel agency in International Postgraduate Medical Foundation v. Commissioner, TCM 1989-36 (1989), and the developers in Columbia Park & Recreation Association, Inc. v. Commissioner, 88 T.C. 1 (1987), aff'd 838 F.2d 465 (4th Cir. 1988). Of course, in most cases, private benefit occurs with respect to entities or persons that have some relationship with the persons controlling the exempt organization.

In American Campaign Academy, the Service argued that the Academy substantially benefited the private interests of Republican party entities and candidates, thereby advancing a nonexempt private purpose. The relationship between the Academy and "Republican party entities and candidates" was not one of control, although the Academy was an outgrowth of a training program operated by National Republican Congressional Committee. In fact, the Academy argued that the prohibition against private benefit is limited to situations in which an organization's insiders are benefited. The Tax Court, however, disagreed with this view, and stated that an organization's conferral of benefits on disinterested persons may cause it to serve a private interest within the meaning of section 1.501(c)(3)-1(d)(1)(ii).

D. Serving Private Interests

The regulations cited above contrast private, non-exempt purposes with public, exempt purposes. Note that it is the organization's true purpose, not the stated purpose or the organizational language, that we must consider. A benefit that is a necessary part of the exempt purpose of the organization does not serve private interests. On the other hand, anything flowing from an organization's activities other than public, charitable benefits may be serving private interests and therefore a nonexempt purpose. Examples include excessive compensation paid to employees, certain payments to outsiders for goods or services, or steering business to a for-profit company. Even activities that appear to further an exempt purpose may serve private interests. An organization may be serving private rather than public interests even though the primary beneficiaries are

members of a charitable class, if the organization provides benefits using criteria other than those that define the charitable class.

The holding in Westward Ho v. Commissioner, TCM 1992-192 (1992) illustrates this point. An organization was created by three restaurant owners to provide funds to “indigent and antisocial persons” to enable them to leave Burlington, Vermont. The Tax Court concluded that the organization’s true purpose was to provide its creators with a more desirable business environment by removing disruptive homeless persons from the area. The organization did not qualify for exemption even though it provided direct “assistance” to members of a charitable class.

In Rev. Rul. 68-504, an organization conducted an educational program for bank employees. It furnished classrooms and employed university professors and others to teach courses on various banking subjects. It had insubstantial social activities. Only members could take courses, but membership was open to all bank employees in the area. In American Campaign Academy an organization conducted an educational program for professional political campaign workers. It furnished classrooms, materials, and qualified instructors. Admission was through a competitive application process.

The actual activity in both cases, teaching a particular subject in a structured, formal way, was the same. So why didn't the Academy qualify for exemption?

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

Discerning the "true purposes" of an organization's activities may sometimes be difficult. The best guide is the actual result or operation of an organization's activities. However, on initial applications, activities may only be proposed and intensive development and analysis must be focused on the creation and organization of the applicant, proposed transactions, and the parties to those transactions.

Other indicators of private purposes are derived from a common sense view of business methods. Most for-profit businesses and well-run exempt organizations deal with a number of different entities to purchase the goods and services they need. They rent office space from one company, buy supplies from another, and go to yet another firm for consulting services. If most goods and services are purchased from one entity, or a group of related entities, private benefit is more likely. Most businesses (and probably most individuals) also compare prices before making significant purchases. While a formal competitive bidding process is not always necessary, the failure to consider alternative sources or to compare prices is another indicator of private benefit.

In est of Hawaii, 71 T.C. at 1081, the court identified certain kinds of contractual provisions as indicating non-exempt purposes. These include agreements not to compete, significant control by a for-profit of an exempt organization's activities, a requirement that the exempt organization maintain exempt status, a lengthy term, and any other provisions that appear to favor the for-profit.

5. Private Benefit in the Real World

At first glance, it appears from the above discussion that straightforward rules or principles can be applied to private benefit issues. American Campaign Academy defines private benefit as “nonincidental benefits conferred on disinterested persons that serve private interests.” Court cases, revenue rulings, and GCMs further define nonincidental, benefits, disinterested persons, and private interests. We understand that private benefit must be both qualitatively and quantitatively incidental. We think we can distinguish between substantial and insubstantial benefits. We believe we can distinguish interested and disinterested persons. We can identify direct and indirect benefits.

In reality it is difficult to apply the private benefit analysis. The Tax Court in Church by Mail may have said it best when it quoted its opinion in Pulpit Resource v. Commissioner, 70 T.C. 612 (1978) and stated that “decided cases provide only broad bench-marks, with the result that the ‘relevant facts in each individual case must be strained through those [established] principles to arrive at a decision on the particular case.’ ” Ultimately, we must take the “facts and circumstances” of each individual case and apply the law discussed above to determine the presence of private benefit. For example, benefits that are nonincidental in one factual situation may be incidental in another given the totality of the circumstances.

Having considered the concept of private benefit in general, let's take a look at some specific cases. Note the amount of detailed information secured during the application process, and how this information was analyzed to arrive at a conclusion.

The first two situations discuss the application of private benefit analysis to two schools. These schools were formed as open-enrollment charter schools, as the term is defined in state law. They entered into charter contracts with the state, pursuant to which they are authorized to establish and operate charter schools, and to receive financial aid from the State Education Agency. The charter contract with the state is in effect for a five-year period. The schools intend to continue operation of the school indefinitely. The schools also entered into management agreements with for-profit corporations to operate and manage the schools.

The third and fourth situations involve low-income housing. Like charter schools, the availability of substantial amounts of government funding (in the form of tax credits

and tax exempt bond financing) make this a fertile area for private benefit. In all four situations, fictitious names are used for easier reading.

Remember, before making the private benefit analysis in an application case, it must first be ascertained that the applicant has an exempt purpose and meets any other requirements for exemption. For example, an organization which intends to provide housing to low income families and individuals must satisfy the safe harbor or facts and circumstances test of Revenue Procedure 96-32, 1996-1 C.B. 717. An organization providing housing to the elderly must relieve the conditions that beset the elderly as a class in accordance with Rev. Rul. 79-18. A charter school must be a school as that term is defined in IRC 170(b)(1)(A)(ii) and the regulations thereunder. In all four situations discussed below, assume that the relevant requirements have been met and focus on the private benefit issues presented.

Situation 1

Oleander Private School was created by Mr. and Ms. Birch, who are husband and wife. They are two of its three directors. Ms. Celosia was selected by Mr. and Ms. Birch as Oleander's third director. Oleander's application lists the address of all three board members as c/o Birch Management Company, a for-profit corporation. Oleander's board does not include any representatives of the community Oleander will serve.

Mr. and Ms. Birch are also Directors of Birch Management Company ("Birch Management"). The management agreement was executed by Mr. Birch on Oleander's behalf and also by Mr. Birch on behalf of Birch Management. The agreement acknowledges that two members of Oleander's Board of Directors have a substantial financial interest in Birch Management, and that the agreement was approved by the third board member.

Mr. and Ms. Birch were instrumental in the creation of Oleander. They incorporated Oleander, prepared the application to become a charter school, and prepared the curriculum and related documents essential for the operation of Oleander.

Birch Management is responsible for the provision of all labor, materials and supervision necessary for the provision of educational services to students, and the management, operation and maintenance of Oleander. Birch Management has sole responsibility and authority to determine staffing levels, and to select, evaluate, assign, discipline and transfer personnel. The school administrator of Oleander is an employee of Birch Management. The school administrator and Birch Management, in turn, have similar authority to select and hold accountable the teachers of Oleander.

Birch Management is compensated 12% of the per pupil expenditures (“PPE”) that Oleander receives and spends from all sources for the students enrolled. PPE is defined to include grants, donations and other student charges in addition to the state per pupil aid received by Oleander. Birch Management is also entitled to an incentive fee of fifty percent (50%) of the excess of revenue over expenditures of Oleander for each year of the agreement.

All costs associated with providing the educational program are Oleander’s responsibility. Those include, but are not limited to, salaries for all personnel, curriculum materials, textbooks, library books, computer and other equipment, software, supplies, building payments, maintenance, and capital improvements.

Birch Management may provide additional programs, including pre-kindergarten, summer school and latch-key programs. Birch Management may also provide food and transportation services to Oleander’s students. Birch Management retains the full amount of any and all revenue collected from these or any other additional program and also is responsible for the full cost.

Birch Management may provide computers, printers, servers, and related equipment, for the classrooms, school offices, and school administration on a lease basis at the prevailing lease rate. Oleander is obligated to pay the prevailing rate for the lease of the computer equipment, and be subject to all of the other terms and conditions set forth in Management Company’s form equipment lease.

Birch Management may terminate the agreement if Oleander makes decisions regarding the personnel, curriculum or program inconsistent with the recommendations of Birch Management.

Discussion

Oleander operates to a substantial degree for nonexempt purposes in that it benefits the Birch family through its management contract with Birch Management.

Generally, the intended beneficiaries of the operation of a school are the students, in the sense that they receive educational benefits. In the case of a school, benefits other than educational benefits or benefits flowing to anyone other than the students should be scrutinized for possible private benefit. In this case, Birch Management benefits from its contractual arrangements with Oleander. While it could be argued that Birch Management, as founder and having directors in common, should be considered an insider for private inurement purposes, technically it is Mr. and Mrs. Birch who are the insiders with respect to Oleander.

In contrast to the preserve the lake situation in Rev. Rul. 70-186, the benefit Birch Management receives is not a necessary result of the operation of the school. Certainly, a school may contract for management expertise; however, it has the option to hire experienced employees or use volunteer staff. To improve the lake water so that the lake can be enjoyed as a public recreational facility, all areas must be improved including areas that do not directly benefit the public – there is no option. Oleander’s educational activities could be performed without benefit being conferred on Birch Management. In fact, Oleander is contracting with Birch Management to have Oleander’s own officers manage and operate the school. Additionally, Birch Management has control of the complete operation of the school, pre-school and after-school programs, hiring, curriculum, materials and all other school functions. Birch Management receives substantial compensation although all costs remain the responsibility of Oleander.

The nature of the benefit appears largely financial, although not all benefits are easily identified. Birch Management receives substantial compensation. It allows Birch Management’s entrance into the charter school arena normally reserved to nonprofit organizations by state statute. It guarantees a significant source of cash flow to Birch Management. It also gives Birch Management access to Oleander’s tax exempt status. As was the case in est of Hawaii and Church by Mail, Birch Management benefits substantially from the operations of the school.

This situation is strikingly similar to that in Church by Mail. In both cases, a non-profit organization was created to further the for-profit interests of its creators. Evidence of this intent is significant. As with the Harberts in Church by Mail, Mr. Birch signed contracts for both Oleander and Birch Management. As in Church by Mail, the Birch family has been significantly benefited. The Court, in Church by Mail, made clear that the reasonableness of compensation was not the pivotal issue; it was the extent of the benefit. The Birch Management has benefited to a substantial extent.

Situation 2

Live Oak School has a three member Board of Directors, which meets annually. The Board of Directors consists of the three members of the original organizational committee.

Prior to Live Oak School's actual formation, its organizational committee contracted with Live Oak Management Company (“Live Oak Management”), a for-profit corporation, to develop and operate the school. Live Oak School looked only at Live Oak Management for services. Live Oak School entered into a Management Agreement with Live Oak Management. The initial term of this contract is 5 academic years and is automatically renewable for successive five (5) year periods. In conjunction with the Management Agreement, Live Oak School has also entered into a Lease Agreement, a

Loan and Security Agreement, a Revolving Note, and a Deficit Coverage Guaranty Agreement with Live Oak Management. All of these agreements are contingent on the simultaneous execution of the Management Agreement. We will describe various provisions in these agreements that work in favor of Live Oak Management.

Management Agreement

Live Oak School entered into a Management Agreement for the organization, implementation and operation of a “complete educational program” with Live Oak Management. This included Live Oak School’s retention of Live Oak Management’s attorney to represent Live Oak School in its formation, application for the charter contract, application for 501(c)(3) status and other legal requirements. The contractual relationship Live Oak School entered into governs the manner in which Live Oak School provides services to the public. The Management Agreement incorporates the charter contract and contains a list of services to be provided by Live Oak Management. The services provided include, but are not limited to, liaison services with the State Chartering Agency regarding continuing to meet the charter contract requirements; ongoing consultation with Live Oak School’s board regarding school management; utilization of Live Oak Management’s operations manuals and forms for teacher contracts, enrollment applications and management procedures; ongoing support on integration of the company-developed curriculum; ongoing teacher training; advice on admissions and terminations; accounting and bookkeeping systems; training school employees; consultation on staff recruitment, selection, evaluation and retention; and consultation on physical plant layout, maintenance and capital improvements.

Live Oak Management will also consult on Live Oak School’s insurance needs by introducing Live Oak School to its insurance providers. It will allow Live Oak School access to its sources of supply to obtain purchasing discounts. Live Oak Management controls Live Oak School’s long term budgeting decisions.

Both this agreement and the charter contract provide that representatives of Live Oak Management will be present at Live Oak School’s board meetings and involved in all planning for Live Oak School’s operations. All decisions must be agreed to by Live Oak Management. Under the terms of this Agreement, Live Oak School has no ability to make decisions independently of Live Oak Management. In addition, Live Oak Management provides the use of its copyrights, trademarks, trade names, etc., as well as various other services.

Live Oak Management is responsible for all labor, materials and supervision necessary for management, operation and maintenance of Live Oak School. Live Oak Management has sole responsibility and authority to determine staffing levels, and to select, evaluate, assign, discipline and transfer personnel. The school administrator of Live Oak School is an employee of Live Oak Management. Live Oak Management has

similar authority to select and hold accountable the teachers of Live Oak School. Live Oak School agrees that for a period of two (2) years after the termination of this agreement, it shall not employ any employee or independent contractor engaged by Live Oak Management.

Live Oak School has agreed to pay a \$50,000 non-refundable payment deemed fully earned when paid, for the Live Oak Management's performance of, among other items, the submission and negotiation of the Charter School Contract and a monthly fee of 12% of the per pupil expenditures ("PPE"). PPE is defined to include grants, donations and other student charges in addition to the state per pupil aid received by Live Oak School. Live Oak Management is also entitled to an incentive fee of twenty-five percent (25%) of the excess of revenue over expenditures of Live Oak School for each year of the agreement. Live Oak School agrees to pay any extraordinary travel and other costs that are pre-approved and additional compensation as mutually agreed upon for services requested that are outside the scope of this contract. Finally, Live Oak School agrees to pay 2% of PPE to be used for advertising. One percent will be used for non-local advertising to benefit the school and other schools using Live Oak Management's proprietary marks with the remaining one percent used for local advertising.

Live Oak Management may provide additional programs, including pre-kindergarten, summer school and latch-key programs. Live Oak Management may also provide food and transportation services to Y's students. Live Oak Management retains the full amount of any and all revenue collected from these and any other additional program but is only responsible for the additional operational cost.

Real Property Lease

Live Oak School entered into a Real Property Lease for the school building with Live Oak Management. It is a standard commercial triple-net lease. Under the terms of the lease, Live Oak School's base annual rent is \$48,000 plus 6% of annual gross revenues in excess of \$800,000. Gross revenues as used in the lease mean all revenues from any source whatsoever and do not specifically exclude donations. As is standard in a triple-net lease, Live Oak School pays as additional rent all of the operating expenses of the building, including insurance, property taxes, utilities, and repairs and maintenance for both the interior and exterior.

Although Live Oak School pays the full operating expenses under this lease, Live Oak School does not have exclusive dominion and control over this property. Live Oak School is entitled to use the premises only between the hours of 7:00 a.m. and 3:30 p.m. when school is in session or on teacher in-service days. Live Oak Management has the right to lease portions of the building to other tenants and to use a portion of the leased premises for office space for its personnel. Live Oak School is required to take full responsibility for this building and indemnify Live Oak Management for any and all

claims arising from the use of the building. Live Oak School is also required to maintain insurance covering both Live Oak School's interest and the Live Oak Management's interest in the property during the term of the lease.

Live Oak School is in default if Live Oak School fails to pay, or otherwise breaches any other term of the lease and does not correct the default within 10 days. Live Oak School waives service of any notice of the intention to terminate. If Live Oak Management chooses to declare the lease in default, it may proceed against Live Oak School for all damages and may elect to terminate the lease. If Live Oak Management elects to terminate the lease, Live Oak School is not entitled to any refund of any fees already paid and must vacate the premises. Any sums that are late bear interest at 18% interest or the maximum rate permitted by law.

Equipment Lease

Live Oak School entered into an Equipment Lease with Live Oak Management for personal property. Personal property includes classroom and office furniture as well as computers and other electronics. This lease, like the Real Property Lease agreement described above, is a net lease in which Live Oak School pays for the right to use the equipment and bears full responsibility for all ongoing operating expenses. The lease provides that Live Oak School accepts the equipment unconditionally and that Live Oak Management bears no liability for any claim, loss or damage caused, directly or indirectly, by the equipment. It also states that Live Oak Management makes no express or implied warranties of any kind, including merchantability or fitness for a particular purpose.

The rental terms for the personal property were set by determining actual cost of the equipment provided (fair market value) and adding a 10% fee for the cost of financing the purchases. Live Oak School is obligated to continue making payments during the term of the lease no matter what happens to the equipment or whose fault it is. Live Oak School is separately responsible for delivery, installation, maintenance and repair. Live Oak School also bears the entire risk of loss and damage. Live Oak School is required to insure both Live Oak School's interest and Live Oak Management's interest in the property.

Revolving Loan and Security Agreement

Live Oak Management, through the Revolving Loan and Security Agreement, also agreed to extend loans of up to \$500,000 to Live Oak School to provide working capital and/or for capital expenditures or improvements. This contract, like the others, is an adjunct to the Management Agreement and is effective only during the term of that agreement.

The Revolving Loan and Security Agreement provides that Live Oak Management will extend credit not to exceed an aggregate outstanding principal amount of \$500,000. All advances are made at the sole discretion of Live Oak Management. The loan is subject to yearly extensions at Live Oak Management's sole discretion and may be terminated earlier on Live Oak Management's demand. Interest on the unpaid principal runs at a fixed rate of 10%. Interest after maturity or default on the principal and unpaid interest runs at 5% above the fixed rate or 15%. The interest is payable on a monthly basis or on demand. In addition to the interest payment, Live Oak School pays an amount of principal necessary to fully amortize the principal balance over a period of 60 months. These interest and principle payments are in addition to any operating surpluses or excess of revenues over expenses that are required to be paid under the Deficit Coverage Guaranty Agreement. In the event that Live Oak School wants to terminate the Agreement under any provision while Live Oak Management has loaned funds to Live Oak School, guaranteed any debt or other financial obligation of Live Oak School, or provided credit support, whether in the form of a letter of credit or otherwise, to Live Oak School, termination is not effective until the loan has been repaid or guarantee has been released.

Live Oak School has provided Live Oak Management a security interest in all of Live Oak School's assets, regardless of whether such collateral is now owned or later acquired. The security interest extends to all equipment (including computers, fixtures, machinery, office and other machinery, furniture ...), all inventory, all accounts, collateral accounts, contract rights, and general intangibles including all of Live Oak School's right, title and interest in any amounts due from the state or any other governmental body. Live Oak School has also agreed that upon default Live Oak Management may take control of all of the collateral without notice.

Under the Revolving Loan and Security Agreement, Live Oak School has the additional affirmative duty to apply for and maintain tax exempt status under section 501(c)(3) of the Code. If Live Oak School breaches any of the affirmative agreements in this contract, Live Oak School will pay all expenses incurred by Live Oak Management in connection with enforcement. Live Oak School gives up its right to make any financial decisions without the consent of Live Oak Management. Live Oak School may not borrow funds from any other source.

Live Oak Management may declare this loan in default if Live Oak School is 5 days late in making payments on the revolving loan or on any other outstanding indebtedness to Live Oak Management. Live Oak Management may also declare the loan in default if Live Oak School breaches any contract provision in the Management Agreement or any other related contract.

Revolving Note

The Revolving Note accompanies the Revolving Loan and Security Agreement. The Note repeats the terms stated in the Agreement and again waives "demand, presentment for payment, notice of dishonor, protest and notice of protest, notice of intention to accelerate, notice of acceleration, diligence in collecting or bringing suit against any party hereto, and all other notices other than as expressly provided in the Loan Agreement." The terms of payment and the timing of payments on this loan are within the discretion of Live Oak Management.

Deficit Coverage Guaranty Agreement

Under the Deficit Coverage Guaranty Agreement, Live Oak Management guarantees all of Live Oak School's operating deficits limited by 1) the annual operating deficit set forth in the school's budget as approved by Live Oak Management and 2) the amount of the revolving note in the amount of \$500,000. To secure this coverage, Live Oak School agrees as follows:

- To submit Live Oak School's budget to Live Oak Management for approval;
- To get Live Oak Management 's approval for any capital expenditure over \$2,500;
- To get Live Oak Management 's approval for any replacement of the principal or business manager and also to promptly notify Live Oak Management of the resignation or termination of the principal or business manager;
- To maintain salary and benefit levels within Live Oak Management 's recommended structure;
- To maintain Live Oak School's non-profit status; and
- To maintain Live Oak School's exempt status under section 501(c)(3) of the Code.

The Deficit Coverage Guaranty Agreement terminates automatically if Live Oak School's Management Agreement with Live Oak Management is terminated. It may also be terminated at Live Oak Management 's election if Live Oak School has two successive years of operating deficits or operating deficits in any 3 out of 5 years; upon 30 days notice; upon Live Oak School's failure to maintain Live Oak School's charter contract; or upon any material change in state funding.

Discussion

The facts in Situation 2 differ from those in Situation 1 in that, although the Board of Directors appears to be unrelated to the Live Oak Management, control of Live Oak

School is ceded to Live Oak Management through the use of a web of related contracts. While the facts differ, much of the analysis used in Situation 1 equally applies to Situation 2. Live Oak Management is a disinterested person and receives a nonincidental benefit from its relationship with Oak Tree School.

The facts above are purposely extensive to highlight the fact that many factors should be considered when reviewing an application for exemption. A partial list of factors one should consider is listed below. The list is, however, *not meant to be all inclusive or that any one factor alone is sufficient to approve or deny exemption.*

- Live Oak School contracted with Live Oak Management prior to Live Oak School's actual formation,
- The Agreements are automatically renewable,
- Live Oak School has entered into multiple contracts with the same for-profit service provider, all of which automatically terminate if one is terminated,
- Live Oak School has contracted for a "complete educational program,"
- Live Oak School used the Live Oak Management's attorney for all its legal needs,
- All decisions considering Live Oak School must be agreed to by Live Oak Management,
- Live Oak Management employs all faculty and staff at Live Oak School including the principal,
- Live Oak School agreed to non-solicitation of employees provision,
- Live Oak Management compensation includes lump-sum payment, a percentage of Live Oak School's total revenue, an incentive fee, reimbursement of costs and a fee for advertising,
- Live Oak School facilities are leased from Live Oak Management on terms that appear to be above market rate,
- Live Oak School equipment is leased from Live Oak Management at terms unfavorable to Live Oak School,
- Live Oak Management has approval rights for Live Oak School's budget,
- Live Oak School must maintain its exemption status under section 501(c)(3).

Live Oak School's relationship with Live Oak Management is very similar to the structure of the organization described in est of Hawaii. Live Oak School purchases everything it needs to operate from Live Oak Management. Live Oak School's ability to remove itself from the Live Oak Management system is severely impaired. If Live Oak School wanted to remove Live Oak Management, it would lose its name, lose its curriculum, lose its facility, lose its equipment, and owe all of the money it had borrowed. As in est of Hawaii, Live Oak School is totally dependent on one for-profit organization for its operation. Live Oak School has, in fact, ceded so much control of its

operations and financial future to Live Oak Management that Live Oak School only operates at Live Oak Management's sufferance.

Situation 3

Mahogany, Inc. has applied for exemption under IRC 501(c)(3). It proposes to develop, own, and operate a nursing home financed by tax exempt bonds. Mahogany is one of several affiliated organizations controlled by an existing entity, Pachysandra. Pachysandra has previously been recognized as exempt under IRC 501(c)(3). Like Pachysandra and its other subsidiaries, Mahogany was formed by an individual, Mr. Zelkova, who is also engaged, on a for-profit basis, in the development, ownership and management of facilities similar to the one described by Mahogany.

Mahogany is governed by a five member board of directors, three of whom also serve as officers. The president of Mahogany is a former employee of a company controlled by Mr. Zelkova. Another of the directors has had past business dealings with Mr. Zelkova. Mahogany's other directors are acquaintances of Mr. Zelkova and were appointed to the board after an interview by the two initial members of the board.

The proposed facility will be financed with the proceeds of tax exempt bonds, will be developed by a partnership in which Mr. Zelkova is a partner (Zelkova LP), will acquire the property from an entity in which Mr. Zelkova holds a substantial interest, and will be managed by a management company (Zelkova Management) owned by Mr. Zelkova. Mahogany represents that all dealings with Mr. Zelkova, whether it be with Mahogany or one of Pachysandra's other affiliates, will either be at cost, or at or below market value depending on the property or service in question. Although the bond offering statement relating to Mahogany's facility has not been drafted, Mahogany submitted an appraisal report for the facility it proposed to construct. This appraisal presented several estimates of value, first "as is" for the value of the vacant land, next upon completion of construction, third upon the project reaching stabilized occupancy, fourth and finally, the highest value was estimated when taking into consideration the value of tax-exempt bond financing. Mahogany proposes to acquire the facility at approximately this last, highest valuation.

Mahogany intends to contract with Zelkova Management to manage the facility. No competitive bids will be solicited because Mahogany views Zelkova Management as uniquely qualified to develop and manage the facility.

Discussion

Clearly the activities of a charitable organization will result in benefits to both its intended charitable class of persons, and to other business entities such as vendors of goods and services required to advance the organization's goals. Benefits to non-

charitable entities are permissible so long as they remain incidental to the accomplishment of the charitable goals of the organization. Deciding whether benefits conferred are incidental to, or one of the intended consequences of, an applicant's proposed activity cannot be decided by a fixed set of principles. Many applicants focus on the class of persons being served to justify their claim to exempt status and ignore or fail to provide information indicating the presence of other motivations. Facts indicating the presence of private benefit are not easy to elicit. Specialists must be aware that benefits in the form of fees, commissions and other payments to developers and contractors can be substantial. Careful scrutiny is necessary to insure an applicant organization is not under the influence of private interests so as to act in a way that benefits those same private interests.

The facts indicate the transaction described above is motivated, in part, by private interests and exemption should not be recognized. This is so even if it were demonstrated that all transactions between Mahogany, other subsidiaries of Pachysandra, and Mr. Zelkova and his companies were at or below fair market value. It benefits Mr. Zelkova and his controlled entities to expand and extend their commercial activities and one purpose of Mahogany is to further that benefit. Further, the transfer price, which takes into consideration the value of the tax exempt bond financing, has the effect of transferring to Mr. Zelkova a benefit intended for Mahogany.

Situation 4

Loganberry, an applicant for IRC 501(c)(3) exemption, will be a partner in a partnership which will own and operate housing for use by low and moderate income families within the safe harbor guidelines in Revenue Procedure 96-32. Loganberry intends to acquire more than 1,000 rental units. A private developer (Dogwood) had previously agreed to purchase these properties from their owners six months before Loganberry's creation. Loganberry stated it was asked by Dogwood if it was interested in forming a partnership to acquire and renovate the properties. Loganberry stated:

Dogwood recognized that to purchase and renovate the properties, a nonprofit joint venture partner was needed to secure key funding sources and facilitate lender and governmental agency approval of the transfers.

To this end, Loganberry and Dogwood executed a joint venture agreement which specified that each property will be held by an individual partnership. Loganberry and Dogwood will be co-general partners in each, with funds being provided by investor limited partners who will obtain tax credits in exchange for their investment. Other terms of the joint venture agreement include the following:

- Dogwood Management Company, an affiliate of Dogwood, will serve as the property manager for each of the properties. Loganberry stated that Dogwood

Management Company was selected as property manager because it is an affiliate of Dogwood.

- Dogwood Management Company is to be paid a fee for its services that is the maximum customary for subsidized projects approved by HUD/USDA;
- Loganberry grants to Dogwood, for a period of two years the right of first refusal to be a joint venture partner with Loganberry if Loganberry should acquire and develop properties not identified by Dogwood.

Pursuant to the joint venture agreement, Loganberry and Dogwood also entered into a Limited Liability Company Agreement (LLC) which took the name of one of the properties identified above. The purpose of this LLC is to serve as the general partner in a limited partnership which also assumed the name of the identified property. The LLC agreement provides that any fees and cash received by the LLC will be split between Loganberry and Dogwood with a higher percentage allocable to Dogwood. In addition, the agreement provides Dogwood Management Company will serve as the manager of any property held by the partnership in which the LLC serves as general partner. Other terms of the agreement make it clear the LLC is to be treated as a partnership for federal tax purposes.

Discussion

The development of real property is an industry with enormous profit potential. Fees associated with the acquisition, development and operation of rental property provide profits to a significant segment of the economy. An organization engaged in the development of low income properties will normally confer the benefit of these fees in the normal course of its activities. Where the organization has bargained to find the best supplier of goods and services to suit its purpose, the benefits conferred will be incidental to the conduct of its charitable endeavors.

In the facts above, however, Loganberry is closely aligned with Dogwood with respect to the property acquisition and development. Based upon the controls maintained by Dogwood there is little to distinguish results obtained by Dogwood from those obtained in a transaction where an organization such as Loganberry is absent, except as regards tax credits. Low Income Housing Tax Credits are allocated by various state agencies established for that purpose. States are required to allocate at least 10% of such credits to organizations that have status under section 501(c)(3) or 501(c)(4) of the Code. Many states, in order to insure compliance with this requirement, give priority to applicants holding exempt status. It appears the only purpose for the presence of Loganberry in the proposed transactions is to enhance the ability of the partnerships to be awarded tax credits permitted by IRC 42. The activities outlined by Loganberry in its application are being undertaken, in significant part, for the benefit of Dogwood and exemption should be denied.