

H. IDENTIFYING ABUSIVE TRANSACTIONS INVOLVING SECTION 501(c)(3) ORGANIZATIONS AND TAX-EXEMPT BONDS

by
Clifford J. Gannett and Gerald V. Sack

1. Introduction

In recent years, the Service has intensified its effort to identify potential abusive transactions involving the use of IRC 501(c)(3) organizations and tax-exempt bonds. Guidance has been provided through various publications including News Releases and Internal Revenue Manual supplements. This article will review those developments and provide additional guidance.

2. Background

In April, 1990, the Service initially alerted charities to three types of tax-exempt bond financed transactions involving the purchase or sale of health care facilities. In News Release IR-90-60, the Service warned that the transactions may result in impermissible private benefit or inurement and the loss of an organization's exempt status.

This warning was augmented by News Release IR-90-107, dated August 21, 1990, which announced the issuance of new determination and examination instructions, Internal Revenue Manual (IRM) sections 7668.(17) and 7(10)7(11). These IRM instructions were drafted to assist Exempt Organizations specialists and agents in detecting potentially abusive transactions in which charitable organizations buy or sell health care facilities financed with tax-exempt bonds. In this News Release, the Service further warned that abusive transactions can have adverse consequences not only for charitable organizations, but also for investors in tax-exempt bonds. If the abusive transaction results in loss of an organization's tax-exempt status, the interest paid on bonds issued by the organization may be taxable to the bondholder.

On April 21, 1993, the Service supplemented the instructions contained in IRM 7668.(17) with respect to processing exemption applications for organizations that intend to use tax-exempt bond financing by issuing IRM Supplement 76G-33. Under this IRM Supplement, organizations applying for exemption under IRC 501(c)(3) were to be asked by determination specialists to provide certain specific information. The information was to enable the determination specialist to complete worksheets designed to assist the specialists in assessing the likelihood of impermissible private benefit and in identifying cases for referral to the National Office.

The IRM Supplement also announced that, if an organization was unable to provide the required information, the key district office could still issue a favorable determination letter if the organization agreed to request a confirmation ruling from the National Office that the organization's tax exempt bond financing would not adversely affect the organization's exempt status. Section 3.016 of the IRM Supplement set forth a special bond paragraph to be included in favorable letters to reflect the organization's commitment to request a confirmation ruling. The Supplement was incorporated by reference into IRM 7668.(16) (previously numbered IRM 7668.(17)) on August 11, 1994. Special bond paragraphs were placed in other favorable determination letters when there was no plan to use tax-exempt financing or where tax-exempt financing plans were fully disclosed.

Both IRM Supplement 76G-33 and IRM 7668.(16) state that the expiration date of the Supplement is October 21, 1994. However, at this writing, the Service continues to process initial applications that indicate tax-exempt financing under MS 76G-33 and IRM 7668.(16). At this writing, revised guidance is currently under review.

Due to staffing and other considerations, the Service decided to discontinue its practice of providing confirmation rulings. Accordingly, the Service discontinued its practice of incorporating all special bond paragraphs in its favorable determination letters. The annual Rev. Proc. 98-8, 1998-1 I.R.B. 225, updating the user fee schedule no longer provides for bond confirmation rulings.

3. Special Emphasis On Tax-Exempt Bond Financed Transactions

While other financial arrangements such as commercial mortgages, taxable bonds and private financing are used by charities in acquiring and constructing facilities, the Service continues to recognize that transactions financed by IRC 501(c)(3) organizations with proceeds of tax-exempt bonds merit increased scrutiny.

The benefits of proactive determination and examination efforts by Employee Plans and Exempt Organizations ("EP/EO") specifically targeting tax-exempt bond financed transactions of IRC 501(c)(3) organizations was cited in a General Accounting Office Report to the Chairman, Subcommittee on Human Resources and Intergovernmental Relations, House of Representatives, GAO/GGD-93-104, dated May, 1993. The report referred to the fact that, during the EP/EO coordinated examination program for tax-exempt organizations, preliminary reviews of organizations' tax-exempt bond-financing transactions had raised new concerns about whether some of the bonds satisfied IRC requirements.

The Report also addressed EP/EO's increased scrutiny of tax-exempt bond financing plans of organizations applying for recognition of exemption under IRC 501(a) by virtue of being described in IRC 501(c)(3). The Report, at page 27, provides:

In another example, after several abusive nursing home deals were publicized widely, in 1991 Employee Plans and Exempt Organizations began emphasizing the review of tax-exempt bond financing plans for organizations applying for tax-exempt status under section 501(c)(3) of the IRC. In a February 1992 presentation, the Director of Exempt Organizations Technical Division said that about 10 percent of the 110 to 115 organizations applying in recent months either withdrew their applications in response to IRS' questions about the proposed bond deals or refused to answer them. Another 10 percent did not have enough information about proposed bond-related transactions for IRS to decide whether tax-exempt status should be granted. The Director interpreted these results as indicating that the special review appears to be stopping potentially abusive tax-exempt bond transactions that were unidentified and unsuspected before revelations on the abusive nursing home deals.

Tax-exempt bonds provide an indirect government subsidy or benefit to IRC 501(c)(3) organizations on whose behalf they are issued. Bondholders of tax-exempt bonds are willing to accept lower interest rates to obtain income exempt from federal tax. Thus, the borrowing costs of IRC 501(c)(3) organizations financing their activities with tax-exempt bonds proceeds is lower. While this benefit is conferred to encourage socially worthwhile endeavors, it also can attract private parties more motivated by the potential of increased profits than insuring that bond proceeds further IRC 501(c)(3) purposes. Thus, the impact of a tax-exempt bond financed project on an organization's tax status under IRC 501(c)(3) should be closely scrutinized.

4. Facts and Circumstances Test

A. Legal Aspects

IRC 501(c)(3) provides exemption from federal income tax for organizations that are "organized and operated exclusively" for religious, educational, or charitable purposes. The exemption is further conditioned on the organization being one "no part of the net income of which inures to the benefit of any private shareholder or individual." Although these requirements overlap, the two are distinct requirements which must be independently satisfied. United Cancer Council, Inc., v. Commissioner, 109 T.C. 17 (1997).

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

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. For the definition of the words "private shareholder or individual," see Reg. 1.501(a)-1(c).

Violation of the statutory inurement proscription may result in initial denial or revocation of an organization's tax exemption under IRC 501(c)(3). However, the Taxpayer Bill of Rights 2, P.L. 104-168, 110 Stat. 1452, enacted July 30, 1996, added IRC 4958 which allows the Service to impose, as a sanction for violations of the inurement proscription, an excise tax on individuals involved.

With respect to the "operated exclusively" requirement of IRC 501(c)(3), Reg. 1.501(c)(3)-1(c)(1) provides that:

An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

The Supreme Court has stated that the presence of a single nonexempt purpose, if substantial in nature, will preclude exemption under IRC 501(c)(3) regardless of the number or importance of the organization's exempt purposes. Better Business Bureau v. U.S., 326 U.S. 279 (1945).

Reg. 1.501(c)(3)-1(d)(1)(ii) also provides that an organization is not organized or operated exclusively for any of the purposes specified in IRC 501(c)(3) unless it serves a public rather than a private interest. Thus, to qualify under IRC 501(c)(3), an organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or the creator's family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

The Tax Court in Alive Fellowship of Harmonious Living, T.C.M. 1984-87 (2-23-84) [& 84,087 P-H Memo TC], states:

The requirement that an exempt organization be operated for public rather than private benefits is but another way of requiring that it be operated exclusively for exempt purposes. Western Catholic Church v.

Commissioner, 73 T.C. 196, 213 (1979), affd. per order 631 F.2d 736 [unpublished order dated 9-19-80] (7th Cir. 1980). The issue is one of fact. Retired Teachers Legal Fund v. commissioner, 78 T.C. 280 (1982).

Under these Code and regulations provisions, there is no bright line test for determining whether impermissible private benefit or inurement exists in a particular tax-exempt financing arrangement. All the facts and circumstances must be available and scrutinized before the Service can arrive at a determination that there is or is not substantial private benefit, inurement, or that the organization is or is not organized and operated exclusively for exempt purposes.

B. Facts to Consider

The impact on IRC 501(c)(3) exempt status of financing with tax-exempt bonds cannot be accurately determined unless all of the salient facts related to the matter are uncovered, weighed, and properly characterized. This most likely will require that the specialists and agents consider, at the minimum, the following general items: 1) the composition of the board of directors; 2) the relationships of the parties to the arrangement; 3) the organization's relationship with other exempt organizations, governmental entities, and banks or guarantors; and 4) the facts surrounding the management of the facility.

Factors indicating that an organization's bond financed project does not adversely affect the organization's status under IRC 501(c)(3) may include, among other items, the following:

- a. The governing board of the organization is comprised of local, independent, civic leaders that broadly represents the community in which the bond financed facility is located.
- b. The organization is controlled by an established IRC 501(c)(3) organization whose exempt purposes are also furthered by the bond financed project. For example, a charity plans to bond finance the construction of an elderly home on the campus of a university. The fact that the university acts as the charity's parent would be a significant fact weighing in the organization's favor.

- c. The organization was created by a local governmental entity to be the lessor in a lease back transaction in which the lessor issues bonds or certificates of participation.
- d. None of the for-profit parties involved in the bond financed project (sellers, developers, contractors, managers, etc.) or individuals connected with them were instrumental in the creation of the organization or exercise substantial influence over the affairs of the organization.
- e. Prior to selecting the bond financed project, the organization had made a good faith effort to find a suitable project.
- f. A feasibility study reflects a projected rate of occupancy that is similar to the actual occupancy rate of the facility being acquired and indicates that the organization will be able to operate the facility in a charitable manner.
- g. An appraisal of the bond financed facility uses the income method, market method, and cost method of valuation to estimate the facility's current business enterprise value.
- h. The organization plans to manage the bond financed facility itself, hire a related exempt organization that has experience managing similar facilities to manage the facility, or selects a manager through competitive bidding.

Factors indicating that an organization's bond financed project may adversely affect the organization's status under IRC 501(c)(3) may include, among other items, the following:

- a. Members of the governing board of the organization are located throughout the country and have no discernable connection with each other or the community in which the bond financed facility is located.
- b. A for-profit developer, manager or other party engaged in bond financed projects throughout the country created and controls the organization.

- c. A for-profit entity involved in the bond financed project loaned the organization funds or paid various costs incurred in the process of organizing the organization and pursuing tax-exempt financing. Such costs might include incorporation fees, application fees, and fees for feasibility studies, appraisals, and engineering and environmental studies.
- d. The for-profit entity selling the bond financed facility to the organization recently purchased the facility and is making a substantial profit on the sale.
- e. The for-profit seller has provided a portion of the financing for the project by purchasing a series of subordinate bonds.
- f. A bank lender or third party guarantor, such as a bond insurer or a letter of credit bank, has final authority over the organization's budget and fees and has required the organization to maintain an unreasonable amount of cash on hand.
- g. The organization has entered into a management contract with a for-profit manager to operate the bond financed facility which provides for the sharing of net profits or provides for penalties if the applicant terminates the contract.

C. Final Disposition of a Case

Where the facts and circumstances show that the tax-exempt financing does not impermissibly benefit private parties and that the organization is organized and operated exclusively for exempt purposes, a favorable determination of the organization's status under IRC 501(c)(3) can be made. If the organization has applied for exemption, a favorable determination letter can be issued.

When an organization, however, cannot provide specific information, representations, or safeguards regarding its bond financed project and cannot describe its activities and its relationships with various parties in sufficient detail, there is an indication that it may be serving private rather than public interests and a favorable letter should not be issued. Reg. 1.501(c)(3)-1(d)(1)(ii) clearly places the burden of proof upon the organization to establish on application for exemption that it is not organized and operated for the benefit of private interests. Failure to provide relevant information regarding the organization's purposes and rules of operation, as well as a detailed explanation of its operations, is a sufficient basis for both the Service and the courts to refuse to recognize the organization as exempt. See Rev. Proc. 90-4, 1990-1 C.B. 410, and Rev. Proc. 90-27, 1990-1 C.B.

514. Simply stated, the organization must establish that it meets the facts and circumstances test prior to being recognized as exempt under IRC 501(c)(3) by the Service.

5. Conclusion

Through various publications, the Service has highlighted its concern regarding the involvement of charities in abusive tax-exempt bond financed transactions. Cases involving such arrangements should be fully developed to determine if the arrangement will result in impermissible private benefit or inurement.