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How To Torpedo Your Tax Exemption: The Fifth Way

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If you're looking for a way to lose your hard-earned section 501(c)(3) tax exemption, we've already written about four roads that will almost certainly get you there: (1) failing to file the required Form 990 three times, (2) dipping your (organizational) toes into the political waters, (3) spending way too much time bending the ears of legislators, or (4) launching a successful business that has nothing at all to do with your official, approved charitable purposes – except to raise money to accomplish them.

Here's your fifth option: Wander away from those aforementioned charitable purposes into the land of too much "private benefit" and – especially – the quicksand of "inurement of your net earnings to private individuals."

One Rule or Two?

Is "private benefit" the same as "inurement"? Is it a single rule? Related rules?

Unfortunately, people in the know, including the IRS, use confusing and contradictory terms: The Private Benefit Rule, The Private Inurement Rule, The No Inurement of Net Earnings Rule – among others. And they use them inconsistently.

Where Does It – or They – Come From?

The starting point is a 132-word statute: section 501(c)(3) of the Internal Revenue Code.

In the land of statutes, that's almost shockingly concise. And the key language is just two particular phrases in that single paragraph that authorizes the most-favored federal tax exemption to qualified organizations.

Should be easy enough to understand and steer away from trouble, right? Once again, though, the devil is in the details.

Section 501(c)(3)

To refresh your memory – or if you're among the readers who probably have never seen it before – here it is:

> Corporations, and any community chest, fund, or foundation, ***organized and operated exclusivelyfor [. . . exempt purposes . . .], no part of the net earnings of which inures to the benefit of any private shareholder or individual***, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office. (emph. added)

We used the officially sanctioned shorthand "exempt purposes" for this text: ". . . religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals . . ."

You'll notice that this statute includes an explicit reference to the "no inurement" prohibition, but makes no mention at all of "private benefit." The concept is there all the same, though: implicit in the requirement that a group be organized and operated exclusively for "exempt" purposes and that none of its money be diverted away from the these qualifying, exempt purposes.

Now, The Regulations

When Congress enacts a law – a statute – the most important clue about it is the plain meaning of the words themselves.

But, like here, where there are just a few – very general – words (and one of them is "inures"), a bit more help is in order.

That's the role of official "regulations." When Congress passes a statute, the federal agency with the responsibility of administering the statute has authority to draft regulations giving us more detail – and maybe a few examples, if we're lucky.

That's what the Exempt Organizations Division of the Internal Revenue Service of the Department of the Treasury has done here in Treasury Regulation section 1.501(c)(3) -1:

> (1)(a)(1) 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 test or the operational test, it is not exempt . . .

The regulations then discuss the "organizational test" – that is, the requirement that a section 501(c)(3) organization's Articles of Incorporation or other governing document include magic language announcing that it will "exclusively" engage in one or more exempt purposes. But there's more: the regulations about the "operational test," that is.

> (c) *Operational test*—
> (1) ***Primary activities***. An organization will be regarded as *operated* ***exclusively*** for one or more exempt purposes only if it engages **primarily** in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if **more than an insubstantial part of its activities** is not in furtherance of an exempt purpose.
> (2) *Distribution of earnings.* An organization is not operated **exclusively** for one or more exempt purposes if its net earnings inure **in whole or in part** to the benefit of private shareholders or individuals. (italics in orig; bolding adding)

Three points:

First: We don't yet see any mention of the term "private benefit." That comes later.

Second: These regulations engage in a sort of gobbledy-gook where the Treasury Department – decades ago – decided that Congress really didn't mean "exclusively" when it wrote "exclusively" in the statute. Instead, it meant "primarily" or "not an insubstantial part of its activities."
This, of course, has not helped accomplish the key goal of federal regulations: to clarify. Most people know what "exclusively" means, but it's anyone's guess what "primarily" means. Or what "an insubstantial part of its activities" means. And that's why – if you follow this blog – you'll get to see many more posts trying to help you understand how to avoid this fifth method of sinking your tax exemption.

Three: Treasury does, indeed, specifically mention "inurement" in subparagraph (2). But . . . doesn't it seem that the agency defines "exclusively" there in a different way than in the subparagraph about primary activities?

This time "exclusively" means just that: An organization's "net earnings" cannot "inure in whole or in part to the benefit of any private shareholders or individuals." No means no. Not even a tiny part of an organization's net earnings can inure away from the organization or its exempt purposes.

Let's continue, over in the definitions section of the regulations:

> An organization is "not organized or operated **exclusively** for one or more [. . . 'exempt purposes' . . .] unless it serves a **public rather than a private interest** . . . 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**. (bolding added)

So this is where we first encounter the concept of "private" + "benefit." And how we arrive at the phrase that is most commonly used as shorthand for this all-important restriction: The Private Benefit Rule.

Or The Private Inurement Rule. Or The No Inurement of Net Earnings Rule. Or Whatever. You'll see them all.

The IRS Website

There's much more discussion and wrangling over these rules – from the IRS, from the Tax Court, from experts and commentators. But here's how the IRS summarizes all of this on its website, under the heading: "Inurement/Private Benefit – Charitable Organizations:"

A section 501(c)(3) organization must not be organized or operated for the benefit of private interests, such as the creator or the creator's family, shareholders of the organization, other designated individuals, or persons controlled directly or indirectly by such private interests. No part of the net earnings of a section 501(c)(3) organization may inure to the benefit of any private shareholder or individual. A private shareholder or individual is a person having a personal and private interest in the activities of the organization.

The website carries no interpretative weight; it's just the agency trying to be helpful. Of course, there's no mention here, of the biggest problem: that "exclusively" really just means "primarily" or maybe "more than an insignificant part of . . . [the] activities .. ."

Conclusion

For – ahem, . . . clarity – we'll refer to all of this as The Private Benefit Rule, a part of which is The No Inurement Rule.

And since a section 501(c)(3) organization can have some, but not too much, private benefit – but absolutely no inurement whatsoever – we're all clear, right?

Then there is “inurement per se” and “excess benefit transactions.”

Stay tuned.