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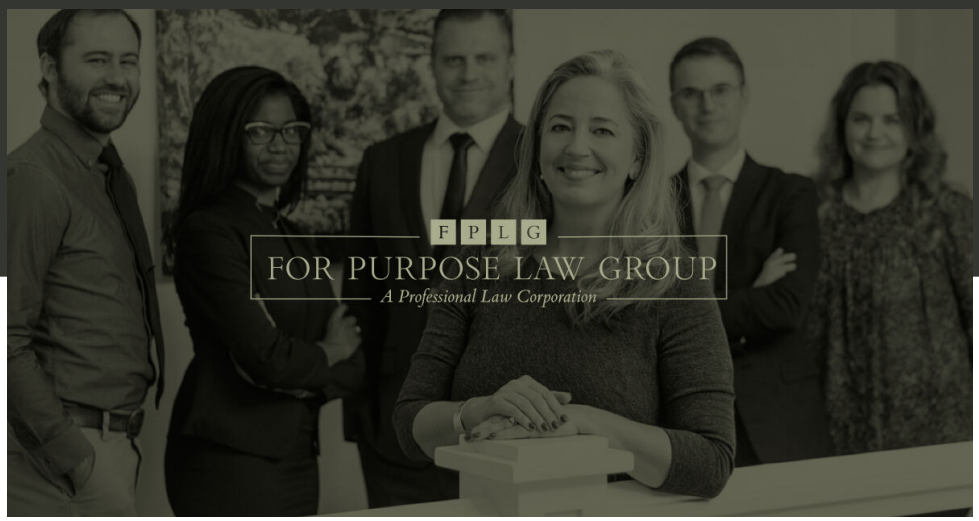
The Private Benefit Rule: Three More Examples

11.12.15 | Linda J. Rosenthal, JD



"If you're looking for a way to lose your hard-earned section 501(c)(3) tax exemption," we explained in an earlier post, here's how: "Wander away from [your] charitable purposes into the land of too much "private benefit" and – especially – the quicksand of "inurement of your net earnings to private individuals."

The often-confused "Private Benefit Rule" and the "No Inurement Rule" come from a single phrase in the 132-word section 501(c)(3) of the Internal Revenue Code, the all-important definitional statute that explains which organizations qualify for the most favored tax-exempt status:

> Corporations, and any community chest, fund, or foundation, ***organized and operated exclusively for [. . . 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)

"The devil," we wrote, "is in the details": how that short and sweet language is interpreted by the Internal Revenue Service and by the courts. In "I Know It When I See It," we highlighted some

examples.

More Guidance

A few years ago, the Treasury Department issued new regulations under section 501(c)(3) with more hypotheticals illustrating key distinctions between the Private Benefit Rule and the No Inurement Rule.

> The purpose of the examples is to illustrate that prohibited private benefit may involve non-economic benefits as well as economic benefits and that prohibited private benefit may arise regardless of whether payments made to private interests are reasonable or excessive.

With some certain stylistic liberties taken, here they are.

The Case of the Genealogy Gurus

An organization applies for tax exemption under section 501(c)(3), describing itself as "educational" – specifically, the study of history and immigration. Its proposed activities include sponsoring lectures and publishing a journal.

But the details are the problem: The organization will focus its historical studies on the genealogy of one particular family, with a goal of publishing a history that will document the pedigrees of individual family members. This group will limit its membership solicitation efforts to only the individuals of that one family. An additional activity will be to identify and locate living descendants of this family line so they can become acquainted.

There's no indication of any money enrichment issues here; indeed, the focus is on an intangible, nonmonetary benefit that applies only to members of this family group.

The Treasury conclusion is that the organization's activities, while arguably "educational" within the meaning of section 501(c)(3) "serve the private interests of members of a single family rather than a public interest. Therefore, [it] is operated for the benefit of private interests in violation of the restriction on private benefit in paragraph (d)(1)(ii) of the 501(c)(3) regulations. Because of this substantial private benefit, the organization is 'not operated exclusively for exempt purposes' and so is not eligible for this tax exemption."

The Case of the Art Advocates

A group of art aficionados – not the Gallery Guys from an earlier blog post – got together to create an art museum. They describe their main activity as promoting the arts by exhibiting works by a group of unknown but promising local artists. They give tours of the art collection.
Here, the trustees have no connection at all to the featured artists. They are just big fans.

But the art is offered for sale in this "museum." The artist sets the price of each piece, and there is a consignment relationship between the artist and the organization. The organization retains 10% of the sale price to cover the facility's operating expenses; the artist keeps 90%. The conclusion by

the Treasury is that the primary activity of the organization is not to promote the arts, but is the private, direct benefit to the individual artists from exhibition and sale of their artwork – which is the organization's sole activity. Under these facts, including that 90% of the proceeds are turned over to the artists, the direct (private) benefit to the artists is not incidental; it's substantial. So the organization is not operated "exclusively for exempt purposes."

The Case of the Program Promoters

An organization describing itself as "educational" trains academics and professionals in a certain program. This program was developed by a fellow who happens to be the president of this organization. All of the rights to the program are owned by a for-profit company owned by this man.

Before the organization was formed, the program was taught by people from the for-profit company. The organization licenses the right to conduct the program and to use the name of the program as part of its own name.

The company provides the organization with the services of trainers and materials. The organization may develop and copyright new course materials based on the program, but all of this must be assigned to the for-profit company (without payment) if and when the license agreement ends.

The for-profit company sets the tuition schedule for the seminars and lectures conducted by the organization.

The organization has also signed a two-year non-competition agreement after any license termination.

The group pays royalties to the for-profit company, which are reasonable in amount.

The Treasury Department doesn't like this cozy arrangement one little bit. The organization's sole activity is conducting seminars and lectures based on the program owned by its president and his for-profit company. Even though there is no issue of the reasonableness of the financial arrangement, the organization is operating for the private benefit of its president and his firm, and not "exclusively for exempt purposes."

Conclusion

In later posts, we'll present more explanations of these key concepts in the law of tax-exempt organizations: some hypotheticals, and some – unfortunately – taken from news headlines about nonprofits that ran afoul of these rules.