

ARTICLE
IN SEARCH OF PRIVATE BENEFIT

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I. INTRODUCTION

For at least the past two decades, the Internal Revenue Service (IRS) has relied heavily on the private benefit doctrine to police economic transactions between tax-exempt charities and for-profit entities. The doctrine has been used to regulate the size of the charitable class needed to justify exemption,¹ prohibit joint-venture transactions between nonprofits and individuals or for-profit entities,² regulate employee recruiting,³ and possibly serve as a substantive constraint on contracts with third parties.⁴ Despite the IRS's broad invocation of private benefit as a policing tool, however (or perhaps *precisely because* of its broad invocation of it), no one really can define the doctrine. The only thing close to an official definition comes from an IRS General Counsel's Memorandum issued in 1987, which noted that:

An organization is not described in section 501(c)(3) if it serves a private interest more than incidentally

A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefitting certain private individuals To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit

1. See *infra* notes 22-28 and accompanying text.

2. *E.g.*, Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94, at *1, *24 (prohibiting an exempt nonprofit hospital from contributing all its operating assets to a joint venture with a for-profit investor unless the nonprofit retains control of the venture); see *infra* notes 64-67 and accompanying text. The doctrine also looms large in joint ventures between exempt organizations and for-profit investors engaged in low-income housing construction. See Jerry O. Allen and Alan D. Duffy, *Solving the Low-Income Tax Credit Housing Partnership Dilemma*, 49 EXEMPT ORG. TAX REV. 319, 323 (2005); see also Nicholas A. Mirkey, *Relinquish Control! Why the IRS Should Change Its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. L.J. 21, 22-23 (2005).

3. *E.g.*, Rev. Rul. 97-21, 1997-1 C.B. 121, 1997 IRB LEXIS 139, at *1-9 (setting forth situations in which physician recruitment incentives are consistent with exemption). In this ruling, the IRS set forth four main principles applying to recruitment incentives, including, "[t]hird, the organization may not engage in substantial activities that cause the hospital to be operated for the benefit of a private interest rather than public interest so that it has a substantial non-exempt purpose." *Id.* (quoting Treas. Reg. § 1.501(c)(3)-1); see *infra* notes 60-63 and accompanying text.

4. *E.g.*, *United Cancer Council, Inc. v. Comm'r*, 165 F.3d 1173 (7th Cir. 1999) (suggesting that the private benefit doctrine might be an appropriate tool to police the contractual relationship between the United Cancer Council and its independent fund-raiser, though rejecting application of the private inurement limitation to this situation); see *infra* notes 69-70 and accompanying text.

conferred by the activity.⁵

This is a quintessential balancing test under which the IRS both owns and reads the scale, leaving charities completely at sea regarding the possible ill effects of transactions with for-profit entities. But the larger problem is that no one even knows what to balance, since practically any transaction undertaken by an exempt charity will result in benefit to some private party outside the charitable class. For example, when the Salvation Army buys food to feed the homeless, food retailers profit from the sales. Ditto for the trailer manufacturers or hotel operators that benefit when the Red Cross provides temporary shelter for disaster victims. We all assume these transactions fall into the “incidental” category and do not result in private benefit problems. But one court decision proclaimed that a “secondary” private benefit flowing to a major political party, as a byproduct of an exempt educational organization that trained political campaign operatives, was not incidental,⁶ and to date only one academic has attempted a more comprehensive explanation.⁷

In an attempt to provide some additional clarity to the doctrine, in September 2005 the IRS proposed regulations that would add some examples to Treasury Regulation § 1.501(c)(3)-1(d)(1)(ii) to illustrate the application of the private benefit doctrine.⁸ These examples, however, are as widely varied as the IRS’s previous invocation of the doctrine and seem at first glance to offer little in the way of guidance concerning what the doctrine means and when it realistically becomes a transactional problem.⁹

In the past I have expressed my displeasure with the private benefit doctrine in writing, explicitly calling for its demise.¹⁰ But I have come to

5. I.R.S. Gen. Couns. Mem. 39,598, 1987 GCM LEXIS 2, at *14-16 (Jan. 23, 1987).

6. *Am. Campaign Acad. v. Comm’r*, 92 T.C. 1053, 1075 (1989).

7. See Darryll K. Jones, *Private Benefit and the Unanswered Questions from Redlands Surgical Services*, 29 EXEMPT ORG. TAX REV. 433, 444 (2000) (arguing that private benefit occurs when “a select and identifiable group [is] granted a priority right of beneficial interaction with [an exempt] entity”).

8. Standards for Recognition of Tax-Exempt Status if Private Benefit Exists or If an Applicable Tax-Exempt Organization Has Engaged in Excess Benefit Transaction(s), 70 Fed. Reg. 53,599, 53,600-02 (proposed Sept. 9, 2005) (to be codified at 26 C.F.R. pts. 1, 53). For a further discussion of these examples in light of the proposals presented in this Article, see *infra* notes 153-65 and accompanying text.

9. See, e.g., Dennis B. Drapkin, *ABA Members Comment on Proposed Regs on Recognition of Tax-Exempt Status, Intermediate Sanctions*, 51 EXEMPT ORG. TAX REV. 159, 160-61 (2006) (“We are concerned, however, that the addition to the regulations of the three relatively narrow examples . . . is likely to produce more confusion than clarification.”) (footnotes omitted).

10. See John D. Colombo, *A Framework for Analyzing Exemption and UBIT Effects of Joint Ventures*, 34 EXEMPT ORG. TAX REV. 187, 194 (2001) [hereinafter Colombo, *Analyzing Exemption*] (“[P]rivate benefit’ should have no appropriate role in analyzing exempt status other than its traditional common-law role of ensuring that a ‘charity’ serves a sufficiently broad charitable

accept that (1) the doctrine isn't going away, (2) it is unreasonable for me to ask the IRS to simply abandon an effective policing tool, and perhaps most importantly, (3) a properly-defined private benefit doctrine has a place in analyzing how exempt entities interact with for-profit entities or individuals. So in place of my past position of "just get rid of it," this Article attempts to identify both a specific rationale for the private benefit doctrine and the paradigm transactions to which it should apply.

Specifically, the Article suggests that the private benefit doctrine should be invoked in cases in which transactions carry substantial risk that the charity is "failing to conserve" charitable assets for the charitable class. I identify two paradigm situations in which the risk of such failure to conserve may be especially high: (1) A charitable entity transacts with an individual or for-profit entity in order to provide "core services" (services that form the basis for tax exemption) to the beneficiaries of the charity (the "outsourcing" paradigm), or (2) the charity enters into a transaction with a for-profit entity or individual involving these core services that confers a competitive advantage on the for-profit in its own business activities (the "competitive advantage" paradigm). In situation (1), the failure to conserve may be the result of paying a profit margin to the for-profit entity to perform services that the charity might be able to provide as efficiently (or more efficiently) directly. In situation (2), the failure to conserve may be the failure to capture the full value of the competitive benefit conferred by the charity on the for-profit. In either situation, the charity should be required to present a reasonable justification that the transaction in question does not "waste" charitable resources in order to maintain the charity's tax exemption.

Since this Article calls for a considerably narrower application of the private benefit doctrine than has recently been the norm, I suspect that when I am done, the IRS may be no happier with my new found appreciation for private benefit than with my prior disdain for it. On the other hand, perhaps recent events, particularly the IRS's promulgation of Revenue Ruling 2004-51 regarding ancillary joint ventures, evidence a new willingness by the IRS to re-examine its use of the private benefit doctrine.

class."); John D. Colombo, *Private Benefit, Joint Ventures, and the Death of Healthcare as an Exempt Purpose*, 34 J. HEALTHL. 505, 521 (2001) [hereinafter Colombo, *Private Benefit*] (arguing that "private benefit as a separate doctrine simply adds nothing to the analysis of the exemption effects of transactions between exempt entities and for-profit investors.").

II. BACKGROUND: HOW WE LOST PRIVATE BENEFIT¹¹

A. *Private Inurement vs. Private Benefit and Early History*

Once upon a time, there was the statute, and only the statute, and the statute said, “Thou shalt not inure.” Or more exactly, the 1909 predecessor to § 501(c)(3) of the Code, which provides tax exemption for “charitable” organizations, contained a limitation that an organization qualified for exemption only if “no part of the profit of which inures to the benefit of any private stockholder or individual.”¹² This “private inurement” language survives in slightly-altered form in today’s § 501(c)(3), providing exemption only if “no part of the net earnings of which inures to the benefit of any private shareholder or individual.”¹³ Meanwhile, in regulations adopted in 1959, the IRS included a phrase in Treasury Regulation § 1.501(c)(3)-1(d)(1)(ii) that forms the basis of the modern private benefit doctrine.¹⁴ This regulation reads:

An organization is not . . . [qualified for exemption] . . . unless it serves a public rather than a private interest. Thus . . . 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.¹⁵

Despite somewhat odd language that invites some strange literal interpretations,¹⁶ the statutory private inurement prohibition has been well-defined over the years through both court decisions and IRS interpretations. The prohibition refers to “siphoning off” the income or assets of the exempt organization via non-arm’s-length transactions with “insiders.”¹⁷ Inurement transactions are usually far from subtle and involve

11. Parts of the discussion in this section are copied or adapted from a previous article I authored and are used with permission. See Colombo, *Private Benefit*, *supra* note 10.

12. 44 Cong. Rec. 4157 (1909), *quoted in* Harvey P. Dale, *The Crux of Charity: Inurement, Private Benefit, and Excess Benefit Transactions*, in NATIONAL CENTER ON PHILANTHROPY AND THE LAW, *DIVERSIONS OF CHARITABLE ASSETS: CRIMES AND PUNISHMENTS* 1, 5 (2004 conference materials) (on file with author).

13. I.R.C. § 501(c)(3) (2000).

14. See Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (2006).

15. *Id.*

16. See Dale, *supra* note 12, at 7-12.

17. See FRANCIS R. HILL & DOUGLAS M. MANCINO, *TAXATION OF EXEMPT ORGANIZATIONS* ¶ 4.03 (2006); BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* § 19.1 (7th ed. 1998); *United Cancer Council, Inc. v. Comm’r*, 165 F.3d 1173, 1176 (7th Cir. 1999) (“A charity is not to siphon its earnings to its founder, or the members of its board, or their families, or anyone

two basic paradigms: (1) The charity pays more than fair market value for property owned by or services provided by an insider, or (2) the charity charges less than fair market value for property or services the charity provides to an insider. So, for example, a charity's paying excessive compensation to an officer constitutes inurement, as does a charity's charging inadequate rent to an officer on property it owns.¹⁸ Today, the private inurement limitation largely has been supplanted by I.R.C. § 4958 (what was once known as the "intermediate sanctions" legislation), which provides statutory remedies short of loss of tax exemption for these siphoning transactions.¹⁹

The private benefit doctrine, on the other hand, does not appear anywhere in the statute. On first glance, the language in the regulation cited above would seem to be little more than an augmented explanation of the statutory private inurement limitation. For example, when the regulation states that an exempt charity must not be "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,"²⁰ it appears that the regulation is discussing mostly *insiders* of the organization: the creator, shareholders, or parties controlled by them. Indeed, the classic *ejusdem generis* maxim of statutory interpretation would call for the general term in this regulation ("private interests") to be limited by the expression of the specific examples, which are *designated individuals, the creator* and *shareholders*, all words that seem to convey an insider relationship with the entity. Perhaps because Treasury Regulation § 1.501(c)(3)-1(c)(1) refers more explicitly to inurement, however, the IRS over the past thirty years has viewed the private benefit language as a

else fairly to be described as an insider, that is, as the equivalent of an owner or manager."); see also Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. 575, 595 (2000) (defining "strict accounting private inurement" as transactions in which assets of an exempt organization are siphoned off to insiders).

18. For a convenient list of, and case citations for, common inurement transactions beyond paying excessive compensation, see, for example, HILL & MANCINO, *supra* note 17, at ¶ 4.03[7].

19. Section 4958 provides for excise taxes on an "excess benefit transaction," defined as a transaction in which "the value of the economic benefit provided exceeds the value of the consideration [] received." I.R.C. § 4958(c) (2000). This is the § 4958 analog to the "siphoning off" concept in private inurement. Excess benefit transactions can occur only between an exempt organization and a "disqualified person," defined as a person who, during the preceding five years, was "in a position to exercise substantial influence over the affairs of the organization." *Id.* § 4958(f). This is the § 4958 analog to the "insider" concept. The IRS retains authority to revoke exempt status for inurement transactions, although most observers agree that revocation will be a sort of "last resort" sanction for egregious or repeated conduct. In fact, much of the proposed regulations project cited in note 8 is concerned with defining situations in which the IRS will revoke exemption for § 4958 violations.

20. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

separate limitation on exempt status.²¹

Nevertheless, there has been considerable historic confusion regarding the scope of the private benefit doctrine. In early rulings and cases, the views of both the IRS and the courts seemed to be that the private benefit doctrine was a restatement of the common law requirement that a charity serve a broad charitable class.²² This requirement comes from the common law of charitable trusts, which the IRS has indicated underlies the definition of “charitable” in § 501(c)(3).²³ Under charitable trust law, for example, a trust set up to maintain a public graveyard was charitable, but not one to maintain an individual’s private tomb.²⁴ In the classic common-law sense, therefore, private benefit referred to a lack of a sufficiently-broad charitable class. Both cases and IRS rulings prior to the latter half of the 1970s seemed to adopt this reading of “private benefit.” For example, in Revenue Ruling 75-286, the IRS held that an organization dedicated to improving one city block (and limiting its members to residents of that block) violated the private benefit prohibition because it did not serve a large enough class,²⁵ even though the IRS had held previously that an organization devoted to beautifying an entire city would qualify.²⁶ At the same time, however, the IRS had recognized that virtually all charitable organizations confer private benefits as a byproduct of performing their charitable services.²⁷ As long as the charitable class served by the organization was broad enough, such incidental benefits would not harm exempt status.²⁸

By the last half of the 1970s, however, the IRS began using “private benefit” in a much different context. The shift in attitude towards private benefit appeared in both certain rulings and litigation positions taken by

21. See Mirkay, *supra* note 2, at 64.

22. See *id.*

23. See Treas. Reg. § 1.501(c)(3)-1(d)(2) (“[C]haritable is used in section 501(c)(3) in its generally accepted legal sense”); *Bob Jones Univ. v. United States*, 461 U.S. 574, 586, 588 (1983) (“[U]nderlying all relevant parts of the Code . . . [are] certain common law standards of charity The origins of such exemptions lie in the special privileges that have long been extended to charitable trusts.”) (footnote omitted); Rev. Rul. 69-545, 1969-2 C.B. 117 (relying on fact that promotion of health had long been considered charitable under the law of charitable trusts as rationale for exempting nonprofit hospital).

24. RESTATEMENT (SECOND) OF TRUSTS § 374 cmt. h (1959); see also AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN, *THE LAW OF TRUSTS* § 375.3 n.8 (4th ed. 1989) (citing numerous cases of charitable trusts).

25. Rev. Rul. 75-286, 1975-2 C.B. 210, 1975 IRB LEXIS 193, at *1, *4.

26. Rev. Rul. 68-14, 1968-1 C.B. 243, 1968 IRB LEXIS 585, at *1.

27. *E.g.*, Rev. Rul. 70-186, 1970-1 C.B. 129, 1970 IRB LEXIS 607, at *3 (finding that organization formed to maintain public recreation area was not denied exemption because it incidentally benefitted owners of shoreline property).

28. *Id.*, 1970 IRB LEXIS 607, at *3.

the IRS at this time.²⁹ For example, in *Harding Hospital, Inc. v. United States*,³⁰ the IRS argued that excessive private benefit resulted from the fact that the existence of the particular psychiatric hospital in question was necessary for the doctors to practice their special “milieu therapy” on patients.³¹ This argument focused not on the size of the charitable class, but on the benefits flowing to other private individuals in serving the charitable class. The Sixth Circuit rejected this argument, but ultimately upheld revocation of exempt status on traditional private inurement grounds.³² Similarly, in a series of cases dealing with “medical practice plans” associated with exempt medical schools, the courts rejected persistent IRS arguments that these plans violated the private benefit doctrine where the facts showed that the doctors involved had received reasonable compensation and thus did not suffer from traditional private inurement violations.³³

This expanded view of private benefit also appeared in IRS rulings. In Revenue Ruling 76-206, the IRS held that a foundation that supported classical programming on an individual radio station was not charitable

29. In fact, one can trace this shift back to Rev. Rul. 69-545, where the IRS ruled that Hospital B in its comparison of exempt (Hospital A) and non-exempt (Hospital B) hospitals was operated for the benefit of private interests given that the hospital’s medical staff was closed and 70% of its board consisted of members of that closed staff who also had owned the hospital as a proprietary institution before converting it to nonprofit status. Rev. Rul. 69-545, 1969-2 C.B. 117, 1969 IRB LEXIS 176, at *3, *7-8. The IRS ruled that under the circumstances, Hospital B was providing a private benefit to the staff doctors. *Id.*, 1969 IRB LEXIS 176, at *8. As with later rulings and litigation positions, this view of private benefit focused on benefits flowing to individuals or entities as a result of serving the charitable class, not on the breadth of the charitable class. *Id.*, 1969 IRB LEXIS 176, at *9-10.

30. 505 F.2d 1068 (6th Cir. 1974).

31. *Id.* at 1076; see John D. Colombo, *Are Associations of Doctors Tax-Exempt? Analyzing Inconsistencies in the Tax-Exemption of Health Care Providers*, 9 VA. TAX REV. 469, 485-86 (1990).

32. *Harding Hosp.*, 505 F.2d at 1078 (concluding that both payment of management fee and below-market office rent are not arm’s-length); see Colombo, *supra* note 31, at 487.

33. See generally *Univ. of Md. Physicians, P.A. v. Comm’r*, 41 T.C.M. (CCH) 732 (1981) (holding that a professional service corporation was tax-exempt because the total compensation paid to physician-employees was reasonable); *Univ. of Mass. Med. Sch. Group Practice v. Comm’r*, 74 T.C. 1299 (1980) (holding that petitioner school group, comprised of teaching members, paid a reasonable salary to its members, and was therefore deemed a charitable organization under § 501(c)(3)); *B.H.W. Anesthesia Found., Inc. v. Comm’r*, 72 T.C. 681 (1979) (holding that organization of teaching anesthesiologists was tax-exempt because physicians were reasonably compensated). All these cases involved a common core of facts: In order to provide higher compensation levels to the teaching doctors at these medical schools, each had formed a “practice plan” that collected fees from the doctors’ private practice of medicine and then paid a certain portion of those fees back to the doctors as compensation. The IRS had argued in each case that the practice plan constituted nothing more than an organization collecting fees for the doctors, and hence excessive private benefit was present even if the doctors were paid reasonable amounts (negating any claim of private inurement). See Colombo, *supra* note 31, at 492-95.

because the monetary support the foundation provided to the radio station was an excessive private benefit.³⁴ In Revenue Ruling 76-152, the IRS found that an art gallery dedicated to displaying and selling the work of a limited number of local artists who received 90% of the sales proceeds was also guilty of excessive private benefit.³⁵ In both these cases, like the litigation position taken by the IRS in *Harding Hospital*, the focus in the ruling was not on the size of the charitable class, but rather the economic benefits that flowed to a for-profit entity or individual as a result of serving the charitable class.

At this same time, the private benefit doctrine also became prominent in IRS rulings dealing with partnership or joint-venture transactions between exempt charities and for-profit entities. Until 1979, the IRS had taken the position that the participation of an exempt entity as a general partner in a joint venture with private investors constituted a per se violation of the private inurement doctrine.³⁶ In 1979, after the Tax Court ruled in favor of an exempt organization's participation in a partnership with private investors in *Plumstead Theatre Society, Inc. v. Commissioner*,³⁷ the IRS reversed course and declared in General Counsel Memorandum 37,852 that joint ventures would not necessarily result in loss of exempt status, and that a case-by-case assessment of such

34. Rev. Rul. 76-206, 1976-1 C.B. 154, 1976 IRB LEXIS 624, at *1, *4-5.

35. Rev. Rul. 76-152, 1976-1 C.B. 151, 1976 IRB LEXIS 621, at *1-4.

36. See, e.g., I.R.S. Gen. Couns. Mem. 37,259, 1977 GCM LEXIS 372, at *1, *8, *14-15 (Sept. 19, 1977) (concluding that a tax-exempt educational organization would lose its exemption if it entered into a contract with a commercial film distributor); I.R.S. Gen. Couns. Mem. 36,293, 1975 GCM LEXIS 215, at *2, *31-32 (May 30, 1975) (entering into a partnership to procure private venture capital to fund a housing project is not compatible with exempt purposes). See generally HILL & MANCINO, *supra* note 17, at ¶ 29.04[1], at 3-44. One should note that an exempt entity's participation in a partnership as a limited partner did not raise similar problems with exempt status, presumably because the exempt organization in such an arrangement had no fiduciary duties to advance the interests of private investors and it would not incur the risk of liability of a general partner. See James J. McGovern, *Partnerships or Joint Ventures as Vehicles to Achieve Charitable Objectives*, 31 CATH. LAW 112, 117-19 (1987).

37. 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982). Plumstead involved a newly-formed exempt performing arts association that decided to stage a play (*The First Monday in October*, featuring Henry Fonda) at the Kennedy Center in order to raise funds for its operations. *Id.* at 1327. To fund production costs for that play, the exempt organization entered into a partnership with private investors. *Id.* at 1328. The IRS claimed the partnership arrangement was inconsistent with exempt status because the duty of Plumstead as general partner was to maximize profits, thus conferring an impermissible private benefit on the limited partners. *Id.* at 1333. The Tax Court held for the exempt organization, however, noting that staging plays was exactly the exempt purpose for which the arts organization was formed, and that none of the limited partners had any control over the operations of the arts organization or the partnership. *Id.* at 1333-34. The play, by the way, apparently was a flop (Plumstead closed the play at a loss). See James J. McGovern, *The Tax Consequences of a Charity's Participation as a General Partner in a Limited Partnership Venture*, 29 TAX NOTES 1261, 1264 (1985).

arrangements would be appropriate.³⁸ In a series of private rulings and General Counsel memoranda that followed, the IRS refined its position, making clear that the primary issue involved in joint venture arrangements focused on the balance between the claimed advancement in charitable purpose from the venture and the private benefits conferred on individual investors.³⁹ Thus in 1983, in General Counsel Memorandum 39,005, the IRS adopted a two-part analysis that first determined whether the objective of the partnership was charitable, and then closely examined the partnership arrangement “to see whether the arrangement permits the exempt organization to act exclusively in furtherance of the purposes for which exemption may be granted and not for the benefit of the limited partners.”⁴⁰ Four years later, in General Counsel Memorandum 39,598,⁴¹ the IRS provided more detailed analysis of private benefit issues. Referring explicitly to the private benefit doctrine, the IRS stated,

An organization is not described in section 501(c)(3) if it serves a private interest more than incidentally. . . . If, however, the private benefit is only incidental to the exempt purposes served, and not substantial, it will not result in a loss of exempt status. . . .

A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefitting certain private individuals. . . . To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.⁴²

Put more succinctly, General Counsel Memorandum 39,598 established private benefit as a major factor separate from private inurement in analyzing the effect of joint ventures on exempt status. This General Counsel Memorandum also established the two main differences between private benefit and private inurement: (1) the approach of balancing public

38. I.R.S. Gen. Couns. Mem. 37,852, 1979 GCM LEXIS 52, at *1-2 (Feb. 15, 1979). See generally HILL & MANCINO, *supra* note 17, at ¶ 29.04[1], at 3-45.

39. See Darryll K. Jones, *Special Allocations and Preferential Distributions in Joint Ventures Involving Taxable and Tax Exempt Entities*, 31 OHIO N.U. L. REV. 13, 23 (2005).

40. I.R.S. Gen. Couns. Mem. 39,005, 1983 GCM LEXIS 56, at *8-9 (June 28, 1983). See McGovern, *supra* note 37, at 1265.

41. I.R.S. Gen. Couns. Mem. 39,598, 1987 GCM LEXIS 2, at *1-2, *31 (Jan. 23, 1987) (finding that a proposed rental of office building space by a subsidiary of an exempt hospital to a group of doctors was inconsistent with exempt status).

42. *Id.*, 1987 GCM LEXIS 2, at *14-16 (citations omitted).

versus private benefit in making case-by-case determinations regarding whether particular transactions had violated the private benefit doctrine,⁴³ as opposed to the general rule that *any* amount of private inurement resulted in loss of exemption, and (2) applying private benefit doctrine beyond “insiders” to any economic arrangement with persons or entities outside the charitable class.⁴⁴

B. *Modern Application: From American Campaign Academy to Revenue Ruling 2004-51*

As of the late 1980s, however, the IRS’s expanded definition of private benefit still awaited judicial approval, which was not long in coming. In *American Campaign Academy v. Commissioner*, the Tax Court analyzed the case of a school that trained individuals to be political campaign professionals.⁴⁵ Although the school clearly served a large charitable class (e.g., it did not limit admissions to particular individuals)⁴⁶ and also clearly met the tests for an “educational organization” under § 501(c)(3),⁴⁷ the Tax Court used the private benefit doctrine to hold that the organization was not exempt.⁴⁸ Noting that most of the school’s graduates worked for the Republican Party or its related entities, the court found that the school benefitted the private interests of the Republican Party to an impermissible degree and hence was not exempt, even though no evidence of traditional private inurement existed.⁴⁹

American Campaign Academy was a watershed in the private benefit doctrine for at least two reasons. First, the court clearly sided with the IRS’s contention that private benefit constituted a separate limitation from private inurement, and was not limited to the traditional “insider

43. *Id.*, 1987 GCM LEXIS 2, at *16-17. The Memorandum appeared to adopt a sort of “but for” analysis in applying private benefit, noting in the ruling that the taxpayer in question had not sufficiently explored alternatives that could have accomplished its objective with less private benefit. *Id.*, 1987 GCM LEXIS 2, at *20-21. In General Counsel Memorandum 39,732, however, the IRS rejected the proposition that a joint venture would pass muster only if the exempt entity could show it was the only way to pursue the charitable purpose at issue, thus apparently burying the “but for” analysis. I.R.S. Gen. Couns. Mem. 39,732 (May 19, 1988). See HILL & MANCINO, *supra* note 17, at ¶ 3.05, at 3-48.

44. See Colombo, *Private Benefit*, *supra* note 10, at 516-17; Dale, *supra* note 12, at 13.

45. *Am. Campaign Acad. v. Comm’r*, 92 T.C. 1053, 1055 (1989).

46. *Id.* at 1058. The court’s opinion indicates some skepticism regarding whether the school took students who did not have Republican Party affiliations, but the record did not indicate such a limitation, and the IRS conceded that the Academy did not discriminate on the basis of race, ethnicity, or national origin. *Id.*

47. *Id.* at 1063 (stating the IRS conceded this point).

48. *Id.* at 1079.

49. *Id.* at 1073-79.

siphoning” of the latter doctrine.⁵⁰ Second, the court adopted the IRS’s “balancing” approach that compared private benefits to outsiders not a part of the charitable class with the direct benefits to the charitable class.⁵¹ The court opinion analyzed both “primary” and “secondary” benefits flowing from the American Campaign Academy (ACA).⁵² The court accepted the fact that the primary benefit of ACA was the education that flowed to ACA’s students, and that, in absence of record evidence that ACA inappropriately limited admissions, the student body was a sufficiently large charitable class.⁵³ Nevertheless, because most of ACA’s graduates ended up working for the Republican Party, substantial secondary private benefit flowed to the Party and hence supported a finding that the Academy was not operated “exclusively” for charitable purposes.⁵⁴

Armed with the approval of *American Campaign Academy*, the IRS quickly made private benefit a cornerstone of exemption analysis. As was the case with the development of the doctrine in the late 1970s and early 1980s, partnership/joint-venture transactions, particularly in the health care sector, became the test beds for the expanded private benefit doctrine post-*American Campaign Academy*. In November 1991, the IRS issued General Counsel Memorandum 39,862, which used private benefit analysis to nix revenue-stream joint venture arrangements between hospitals and doctors.⁵⁵ These arrangements, in which hospitals would “spin-off” certain outpatient services to a joint venture between the hospital and doctors, were used by hospitals as a means of increasing utilization of hospital facilities by giving doctors a direct economic stake in the spun-off facility.⁵⁶ The hope was that the participating doctors would refer more patients to the facility, thus increasing revenues to the hospital. In the Memorandum, the IRS ruled that these arrangements violated the private benefit doctrine, because the direct and substantial financial benefit to the participating doctors could not be justified as incidental to the hospital’s mission of providing health services to the community.⁵⁷ According to the IRS, “Obtaining referrals or avoiding new competition may improve the competitive position of an individual hospital, but that is not necessarily

50. *Id.* at 1069.

51. *Id.* at 1074-76.

52. *Id.*

53. *Id.* at 1071-74.

54. *Id.* at 1073-79. “Exclusively” really means “primarily” in this context. *See* Treas. Reg. § 1.501(c)(3)-1(c) (2006).

55. I.R.S. Gen. Couns. Mem. 39,862, 1991 GCM LEXIS 39, at *1-2. (Nov. 22, 1991).

56. *Id.*, 1991 GCM LEXIS 39, at *1-2; *see also* 1 DOUGLAS M. MANCINO, TAXATION OF HOSPITALS AND HEALTHCARE ORGANIZATIONS § 19.04 (2005) (noting that net revenue stream joint ventures were used by hospitals as a means of “solidifying a referral base or deterring the physicians from establishing their own, competing, facilities and services”).

57. *See* I.R.S. Gen. Couns. Mem. 39,862, 1991 GCM LEXIS 39, at *1-2 (Nov. 22, 1991).

the same as benefitting its community.”⁵⁸ The IRS, however, indicated in a later part of the Memorandum that if a joint venture was needed to expand health care resources in the area, create a new provider, reduce treatment costs, or provide new treatment modalities, then the arrangement might pass muster.⁵⁹

The private benefit analysis also played a key role in two major healthcare exemption rulings released by the IRS in the late 1990s. Revenue Ruling 97-21, dealing with physician recruitment, involved two separate situations.⁶⁰ The first concerned financial incentives to recruit a physician to be an employee of a hospital or other provider, and the second related to financial incentives to recruit doctors to the community to be on staff, but not as employees of the hospital.⁶¹ While private inurement analysis controlled the first situation, the IRS relied on private benefit analysis in the second, holding that reasonable incentives would be permitted when the recruitment was justified by community need, expanding services provided by the hospital, or providing new services to the community.⁶² Recruitment that simply enhanced the hospital’s own bottom line (by recruiting a physician already in the community and providing services to the community at another hospital) would not be permitted under the private benefit test, presumably because such a move would not enhance services to the community.⁶³

In the second major ruling, Revenue Ruling 98-15, the IRS examined the whole-hospital, joint-venture transaction in which an existing exempt hospital corporation would contribute all its assets (the hospital building, equipment, contracts with staff and providers, etc.) to a joint venture with a for-profit hospital chain.⁶⁴ Typically, these transactions were structured as fifty-fifty partnerships. The for-profit provider would contribute cash to the deal, equal to the value of the assets contributed by the exempt partner, and a for-profit management company (usually affiliated in some way with the for-profit partner) would manage the business via a contract with the partnership.⁶⁵ Using private benefit analysis as its main analytical

58. *Id.*, 1991 GCM LEXIS 39, at *30-47.

59. *Id.*, 1991 GCM LEXIS 39, at *67 (“We recognize that there may well be legitimate purposes for joint ventures, whether analyzed under the anti-kickback statute or the Tax Code. These may include raising needed capital; bringing new services or a new provider to a hospital’s community; sharing the risk inherent in a new activity, or pooling diverse areas of expertise.”).

60. Rev. Rul. 97-21, 1997-1 C.B. 121, 1997 IRB LEXIS 139, at *1-2.

61. *Id.*, 1997 IRB LEXIS 139, at *14-16.

62. *Id.*, 1997 IRB LEXIS 139, at *16-19.

63. *See id.*, 1997 IRB LEXIS 139, at *8, *19-20; 1 MANCINO, *supra* note 56, at § 20.02[4][f].

64. Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 97, at *1.

65. For extended discussions of this ruling, see 1 MANCINO, *supra* note 56, at § 19.04[5][a]; THOMAS K. HYATT & BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS* ¶ 22.9, at 373-78 (2d ed. 2001).

tool, the IRS concluded that these whole-hospital joint-venture arrangements were consistent with exempt status only if the exempt partner retained control over the management of the joint venture, a position later upheld by the courts.⁶⁶ The IRS noted that in cases where the exempt organization did not retain management control, it could not initiate programs to meet the health needs of its community, and other community benefit programs such as free care for the poor could be terminated.⁶⁷ As in General Counsel Memorandum 39,862, the IRS refused to view the economic advantages of the joint venture arrangement as a sufficient counterbalance to the private benefits flowing to the for-profit partner and the for-profit management company.

Finally, private benefit made a gratis appearance in Judge Posner's opinion in *United Cancer Council, Inc. v. Commissioner*.⁶⁸ The defendant-charity United Cancer Council (UCC) had entered into an agreement with a private, for-profit fundraising firm, Watson & Hughey.⁶⁹ Of the \$28.8 million raised, only \$2.3 million actually went to UCC—less than 10% of the gross.⁷⁰ Although the case primarily centered on the issue of whether an arm's length agreement with a for-profit fundraiser could result in private inurement (a proposition soundly rejected by the Seventh Circuit), at the close of his opinion, Judge Posner suggested that the private benefit doctrine could provide an alternate means of supervising "bad" agreements between exempt charities and for-profit outsiders:

Suppose that UCC was so irresponsibly managed that it paid W & H twice as much for fundraising services as W & H would have been happy to accept Then it could be argued that UCC was in fact being operated to a significant degree for the private benefit of W & H

. . . [A] violation of [a governing board's duty of care] which involved the dissipation of the charity's assets might (we need not decide whether it would—we leave that issue to the Tax Court in the first instance) support a finding that the

66. *E.g.*, *St. David's Health Care Sys., Inc. v. United States*, 349 F.3d 232, 235-37 (5th Cir. 2003). The IRS control analysis in this ruling was largely approved by the courts in these cases, although the courts seemed to be more willing to consider whether the joint venture arrangement provided practical control over partnership activities, rather than strict voting control, in determining exempt status. *Redlands Surgical Servs., Inc. v. Comm'r*, 113 T.C. 47, 79-83 (1999), *petition for review denied*, 242 F.3d 904 (9th Cir. 2001). *See, e.g.*, 1 MANCINO, *supra* note 56, at § 19.04[5][b], [c]; HYATT & HOPKINS, *supra* note 65, at § 22.11, 378-90 (discussing *Redlands*).

67. Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94, at *21.

68. *United Cancer Council, Inc. v. Comm'r*, 165 F.3d 1173, 1174-75 (7th Cir. 1999).

69. *Id.*

70. *Id.* at 1175.

charity was conferring a private benefit⁷¹

C. *The Ancillary Partnership Ruling: Where Did Private Benefit Go?*

By 2004, therefore, the private benefit doctrine appeared to be firmly entrenched as a cornerstone of IRS oversight of exempt charities. The potential application of private benefit had expanded from the common-law rule requiring a broad charitable class to a doctrine that potentially encompassed any benefit (economic or not) flowing to for-profit entities or individuals as a result of serving the charitable class. Then a strange thing happened: In one of the most anticipated exemption rulings of the new millennium, private benefit analysis disappeared.

Ever since the IRS issued Revenue Ruling 98-15 on whole-hospital joint ventures, both private commentators and the IRS had recognized the need for a follow-up ruling on what had become known in the trade as “ancillary” joint ventures.⁷² While not legally defined, the phrase “ancillary joint venture” has come to describe a partnership between an exempt charity and a for-profit entity involving some significant, but “small,” part of the activities of the exempt charity.⁷³ In the hospital context, where the phrase appears to have been coined, ancillary joint ventures were those that involved some “spin off” of a portion of the hospital’s operations, such as an outpatient surgery facility (in contrast to the “whole hospital” joint venture, where the hospital contributed all its assets and operations to the partnership).⁷⁴ In particular, the practicing bar had complained that the imposition of the “control” test of Revenue Ruling 98-15 on ancillary joint ventures was unrealistic.⁷⁵ IRS officials, in turn, appeared to recognize that ancillary partnerships might need a different analysis than provided by Revenue Ruling 98-15.⁷⁶

71. *Id.* at 1179-80.

72. *E.g.*, J. Christine Harris, *Practitioners Hope to See Joint Ventures, Section 527 Issues in 2002 EO CPE Text*, 33 EXEMPT ORG. TAX REV. 378, 379 (2001).

73. *See* Mirkay, *supra* note 2, at 23; HYATT & HOPKINS, *supra* note 65, at § 22.11, at 378. I have put the word “small” in quotations because I am not using the word in the sense of a comparison of revenues or expenditures or other such mathematical tests. Rather, an “ancillary” joint venture is defined by the fact that the exempt participant still carries on a substantial charitable program apart from the activities of the joint venture. “Small” in this sense means a qualitative, not necessarily quantitative, judgment, though in the health care arena, “ancillary” joint ventures do tend to represent a relatively small portion of the overall revenues and services provided by the exempt participant.

74. *See* Mirkay, *supra* note 2, at 23.

75. *See, e.g.*, J. Christine Harris, *EO Repts Call IRS’s Stance on Joint Ventures ‘Unrealistic,’* 40 EXEMPT ORG. TAX REV. 9, 10 (2003); Barbara Yuill, *No IRS Private Rulings on Way for Charitable Hospital Joint Ventures*, 10 HEALTH L. REP. 1867 (2001). This latter article quotes T. J. Sullivan, a prominent practitioner, stating the IRS “‘needs to adopt a workable position on ancillary joint ventures that don’t fit’” within the paradigms laid out in Rev. Rul. 98-15. Yuill, *supra*, at 1867; *see also* Mirkay, *supra* note 2, at 52-53.

76. *E.g.*, Fred Stokeld, *IRS Branch Chief Clarifies Guidance on Hospitals’ Joint Ventures*,

In early 2004, the IRS finally issued Revenue Ruling 2004-51 on ancillary partnerships.⁷⁷ Using the fact pattern of an exempt university partnering with a for-profit firm to provide distance education services (which the Service noted was an “insubstantial” part of the university’s activities), the ruling held that such partnerships would not endanger exempt status for the nonprofit participant, even if the exempt partner did not have control over the venture (in the facts, the university and for-profit partner shared control fifty-fifty, although in the ruling the IRS noted that the exempt university retained control over curricular matters).⁷⁸ The ruling, however, contained one major surprise: a total lack of any reference in the analysis section to private benefit.⁷⁹ In fact, the entire analysis of the tax exemption issues is contained in two sentences in the ruling:

The activities M [(the exempt participant)] is treated as conducting through L [(the joint venture)] are not a substantial part of M's activities within the meaning of § 501(c)(3) and § 1.501(c)(3)-1(c)(1). Therefore, based on all the facts and circumstances, M's participation in L, taken alone, will not affect M's continued qualification for exemption as an organization described in § 501(c)(3).⁸⁰

The disappearance of private benefit analysis from the ancillary partnership ruling is a curious thing. If private benefit is to be judged using a balancing test on a transaction-by-transaction basis (as General Counsel Memorandum 39,862 and other IRS positions set forth above tell us), and if in the partnership situation impermissible private benefit exists unless the charitable partner maintains control over the partnership (as the IRS claims in Revenue Ruling 98-15), then the IRS should have explained in the ruling why this transaction passed the private benefit test despite the lack of control by the exempt institution over the partnership. But the IRS did not do this. Why? The answer appears simple: To have discussed and dismissed private benefit concerns, either the IRS would have had to admit that the control test presented in Revenue Ruling 98-15 was too rigid, or

Charity Care, 33 EXEMPT ORG. TAX. REV. 203, 204 (2001) (“Friedlander also sought to allay fears that any partnership activity by nonprofit hospital systems could jeopardize exemption. Minor partnership activity will not endanger exempt status, though the activity may be taxed, he said.”).

77. Rev. Rul. 2004-51, 2004-1 C.B. 974, 2004 IRB LEXIS 201.

78. *Id.*, 2004 IRB LEXIS 201, at *12. The ruling also examined the unrelated business income tax (UBIT) implications of the arrangement, holding that under the facts of this specific case, the activities of the venture were “substantially related” to the university’s educational purpose and therefore revenues from the venture were not subject to the UBIT. *Id.*, 2004 IRB LEXIS 201, at *10, *12.

79. The ruling did cite the “usual suspects” in the “law” section of the ruling, including Treas. Reg. § 1.501-(c)(3)-1(d) and the *Redlands Surgical Services* and *St. David’s* cases, but did not refer to these sources in the analysis section. *Id.*, 2004 IRB LEXIS 201, at *4-7.

80. *Id.*, 2004 IRB LEXIS 201, at *10 (emphasis omitted).

else that its transaction-by-transaction approach was incorrect (e.g., even if private benefit existed in the ancillary partnership, it should not outweigh the fact that most of the university's activities were classically charitable educational activities aimed at a broad charitable class). Either possibility would have required the IRS to directly overrule a firmly-entrenched prior position that had won court support (see above), and doing so obviously presented some distasteful options. So instead, the IRS adopted the time-honored tradition of ignoring problems you would rather not confront, leaving the rest of us to speculate on the cosmic meaning of the ruling and what, if anything, it had to say about the private benefit doctrine.⁸¹

D. *Still Alive: Credit Counseling and Down-Payment Assistance*

Although the ancillary joint venture ruling raised questions about the scope and viability of the private benefit doctrine, recent IRS actions make clear that the doctrine is alive, well, and a continuing major part of IRS enforcement efforts. An ongoing audit program of tax-exempt credit counseling organizations started in 2003 has resulted in the revocation of exemption for forty-one of sixty-three audited organizations so far,⁸² with private benefit playing a major substantive role in the rationale for revocation.⁸³ A memorandum from the IRS Office of Chief Counsel issued in 2004 advised that “we will need to argue that, even if [credit counseling agencies] are providing education, the organizations fail the operational test: they are furthering a substantial nonexempt purpose, and furthermore they are conferring impermissible private benefits”⁸⁴ Later in this

81. Several high-profile practitioners expressed satisfaction with the ruling immediately after its release. See, e.g., Fred Stokeld, *Practitioners Pleased with Revenue Ruling on Ancillary Joint Ventures*, 44 EXEMPT ORG. TAX REV. 284, 284 (2004). Later articles, however, pointed out several things the ruling left open, such as whether ownership of less than 50% by the exempt partner would result in exemption problems, or whether joint ventures that failed the “relatedness” test of the unrelated business income tax would be judged differently. For example, Michael I. Sanders, who was quoted in Stokeld’s article as being initially favorable to the ruling, was later critical of its limitations. *Id.*; see also J. Christine Harris, *Tax Law Professors Say Recent Joint Venture Ruling Doesn’t Break Ground In Housing*, 47 EXEMPT ORG. TAX REV. 21, 21 (2005); Mirkay, *supra* note 2, at 58-59. My own view is that the ruling constituted a *sub-silentio* “relaxation” of the control requirement—note the stress in the ruling on the fact that the university in question controlled the parts of the venture dealing with educational policy—and was a signal that, as the court decisions in *Redlands Surgical Services* and *St. David’s* seemed to indicate, something short of voting control over a venture could still meet charitable criteria. See *supra* notes 66-67 and accompanying text.

82. See Fred Stokeld, *Everson Announces Credit Counseling Enforcement Initiative*, 52 EXEMPT ORG. TAX REV. 250, 250 (2006). The remaining twenty-two cases were still pending as of June 2006. *Id.* By the time this Article appears in print, it is possible that all sixty-three organizations will have lost their exemption.

83. See *id.*

84. I.R.S. Chief Couns. Mem. 200,431,023 (July 30, 2004) available at <http://www.irs.gov/>

memorandum, the IRS laid out its main private benefit argument: That many or most modern credit counseling agencies violated the private benefit doctrine because the agencies' operations directly benefitted the "back-office service providers" with whom the agencies had contractual arrangements to promote debt consolidation loans, credit repair services, buying clubs, down-payment assistance, and even dietary supplements.⁸⁵ In essence, the IRS position is that credit counseling organizations are entering into exclusive deals with back-office service providers through which the credit counseling organization "offloads" most of the actual services, while at the same time selling services to its ostensibly charitable beneficiaries that provide substantial profits to for-profit third parties.

Even more recently, the IRS published Revenue Ruling 2006-27, in which it analyzed exemption for organizations that provided cash down-payment assistance grants to poor individuals to help purchase housing.⁸⁶ Situation 2 of this ruling involved an organization that provided this assistance largely via payments from the home seller (that is, the seller would make a "donation" to the organization, which in turn would transfer this amount, less fees, to the buyer as down-payment assistance).⁸⁷ In this situation, the IRS concluded that the circular cash flow (from seller to organization to buyer then back to seller) constituted an impermissible private benefit to the sellers and real estate brokers involved in the transactions, despite the fact the organization "also serves an exempt purpose."⁸⁸

III. FINDING PRIVATE BENEFIT

A. *Policy Aspects: What Evil Does Private Benefit Prevent?*

The morphing of private benefit from a doctrine focused on the size of the charitable class to one that encompasses virtually any transaction between an exempt charity and non-exempt entities or individuals and the conspicuous absence of the doctrine from Revenue Ruling 2004-51, present strong evidence that something is amiss with the definition of private benefit. Indeed, the problem is that the doctrine currently has no theoretical grounding to set its outer boundaries. While the bounds of private inurement have been well defined as a siphoning off of charitable assets to an insider, private benefit seems to encompass all sorts of economic transactions (or even, as with *American Campaign Academy*, no

pub/irs-wd/0431023.pdf.

85. *Id.*

86. Rev. Rul. 2006-27, 2006-21 I.R.B. 915, 2006 IRB LEXIS 207.

87. *Id.*, 2006 IRB LEXIS 207, at *3-4.

88. *Id.*, 2006 IRB LEXIS 207, at *19.

economic transaction at all) with insiders or outsiders (even when, as the IRS concluded in Revenue Ruling 2006-27, the organization “also serves an exempt purpose”)⁸⁹ without any clear guidance as to why individual transactions create these problems. So perhaps we should begin the journey of finding private benefit by returning to the potential policy reasons for the doctrine and its relationship to private inurement and the general “primary purpose” test for exemption—in other words, we should begin by asking what evil the doctrine is designed to avoid.

Charitable organizations must primarily pursue a charitable purpose in order to be eligible for exemption.⁹⁰ As a policy matter, that is why we grant exemption in the first place: to encourage/enable these organizations to pursue purposes that under one theory or another we believe are deserving of special tax treatment.⁹¹ This requirement of primarily pursuing a charitable purpose is at the heart of the Treasury Regulation’s “operational” test for exemption.⁹²

As noted above, historically the private benefit concept has been used to identify whether a charity was actually engaged in a charitable purpose at all—that is, whether the charity was serving a broad charitable class.⁹³ We could simply return private benefit to this historical role, but before we do so, we should explore whether there is some reason to broaden the definition of private benefit beyond that historical one, as the IRS has done over the past thirty years.

One possibility for an expanded definition relates to the primary purpose requirement. Under this view, the “evil” identified by an expanded view of private benefit is that a charity has become more concerned with serving private interests than in delivering charitable services—in essence, private benefit is simply a specialized way of saying that a charity no longer is *primarily* pursuing a charitable purpose, but instead has become

89. *Id.*, 2006 IRB LEXIS 207, at *19.

90. Treas. Reg. § 1.501(c)(3)-1(c) (2006). Though the statute states that an entity is exempt only if it is organized and operated “exclusively” for charitable purposes, this statutory directive has long been interpreted as requiring the organization to operate “primarily” for charitable purposes. *See, e.g.*, *New Dynamics Found. v. United States*, 70 Fed. Cl. 782, 799 (Fed. Cl. 2006) (“‘Exclusively’ in this statutory context is a term of art and does not mean ‘solely.’ Rather, an organization is ‘operated exclusively’ for exempt purposes if it engages in primarily exempt activities.”) (citation omitted).

91. Unlike perhaps all the rest of tax law, tax exemption has no clearly-defined underlying theory. Commentators have variously explained exemption as a government subsidy or government non-interference for organizations that broadly benefit the community, that relieve the government of the necessity of providing certain services directly, that produce goods/services not produced by the private market, or that promote the pluralistic ideal in our society. For an overview, see JOHN D. COLOMBO AND MARK A. HALL, *THE CHARITABLE TAX EXEMPTION 19-96* (1995); JAMES J. FISHMAN AND STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS 327-48* (3d ed. 2006).

92. For a general discussion of the operational test, see HOPKINS, *supra* note 17, at § 4.5.

93. *See supra* notes 22-28 and accompanying text.

a ““for-profit in disguise.””⁹⁴ The difference between this view and the historical definition of private benefit is that under this view, an organization might still be serving a large enough charitable class, but that doing so has become secondary to benefitting entities or individuals outside the charitable class. Think, for example, about a nominally nonprofit hospital whose board is controlled by a small group of doctors who have the only admitting privileges to the hospital. In this case, one might argue that the hospital is still providing health care for a broad enough charitable class, but the overriding purpose of the hospital is to benefit the controlling doctors by providing them with a closed, preferential system in which to practice medicine—that is, in this case, serving the charitable class has become secondary to serving the private interests of the doctors.⁹⁵

There is certainly language in IRS rulings and court cases that would suggest this is the proper interpretation of private benefit. For example, in the key rulings set forth above in which the IRS has applied private benefit analysis, it routinely cites the operational test for exemption;⁹⁶ even the court in *American Campaign Academy* concluded that the excess of private benefit meant that the organization was no longer primarily operated for charitable purposes.⁹⁷

This suggestion, however, does not really help focus a definition for a separate concept of private benefit. If private benefit is nothing more than saying that an organization is no longer primarily pursuing a charitable purpose, then it does not offer much beyond the primary purpose test. It does not answer the question, for example, why we should be particularly concerned about charities entering into joint-venture transactions with for-profit organizations, an area which the history recounted above indicates has been the primary breeding ground for the IRS’s expanded interpretation of private benefit. Nor does it address Judge Posner’s suggestion in *United Cancer Council* that “bad deals” could result in private benefit even if those bad deals were earnestly pursued in order to serve the charitable class, as was undoubtedly true in that case.⁹⁸

The actual scope of the private benefit doctrine as implemented, moreover, indicates that the IRS really does not see private benefit as

94. Economist Burton A. Weisbrod is the originator of this phrase. Burton A. Weisbrod, *The Nonprofit Mission and Its Financing*, in *TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR* 11 (Burton A. Weisbrod ed., 1998).

95. This example is Hospital B from Rev. Rul. 69-545, 1969-2 C.B. 117, 1969 IRB LEXIS 176, at *3-4.

96. See, e.g., Rev. Rul. 2006-27, 2006-21 I.R.B. 915, 2006 IRB LEXIS 207, at *5-10 (citing the operational test of Treas. Reg. § 1.501(c)(3)-1(c)(1)); Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94, at *8-9 (same).

97. *Am. Campaign Acad.*, 92 T.C. 1053, 1079 (1989).

98. *United Cancer Council, Inc. v. Comm’r*, 165 F.3d 1173, 1179 (7th Cir. 1999).

simply a substitute for the primary purpose rule. If we are to believe the IRS's transactional approach, then private benefit (like private inurement) can cause a loss of exemption if a single transaction involves private benefit, even when the overall operations of a particular organization are more charitable than not (i.e., primarily charitable). I would suggest that there is little doubt that the hospitals engaged in the revenue-stream joint ventures described above in General Counsel Memorandum 39,862 were still primarily centered on a mission of providing health services to the general population, a purpose that the IRS recognized as charitable in Revenue Ruling 69-545.⁹⁹ Moreover, in its private benefit rulings, the IRS likes to stress the quotation from the old *Better Business Bureau* case that "the presence of a single [non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] purposes."¹⁰⁰ This quote supports the conclusion that private benefit, like private inurement, is a problem even when charitable purposes might globally outweigh a private benefit transaction. Despite the final conclusion of the court in *American Campaign Academy*, moreover, the crux of the opinion was that the organization in question failed exemption because of *secondary* benefits, not because it failed to provide *primary* charitable services to a charitable class.¹⁰¹ So it seems that, despite the citations to the primary purpose rule in various rulings, the IRS does not *really* treat private benefit as simply shorthand for the primary purpose test, but rather as a separate limitation on an organization that arguably in fact has a primary charitable purpose. In any event, if private benefit is to be useful as a separate concept, it must be more than just a shorter way of saying that the charity no longer has a primary charitable purpose.

A second set of possible evils relates specifically to economic transactions. As noted above, the private inurement limitation and I.R.C. § 4958 identify as one evil the situation in which a charity diverts assets for less than fair market value to for-profit interests.¹⁰² But private inurement/4958 covers only situations in which the diversion involves insiders (as broadly defined by § 4958), and even then covers only situations in which the exchange is not at fair market value (that is, the charity receives less economically than it gives up).¹⁰³ One immediate question that arises, therefore, is whether one can conceive of such diversion transactions that do not involve insiders or whether there might be situations in which even transactions that occur at fair market value are

99. Rev. Rul. 69-545, 1969-2 C.B. 117, 1969 IRB LEXIS 176, at *5.

100. *Better Bus. Bureau of Washington, D.C., Inc. v. United States*, 326 U.S. 279, 283 (1945); *see, e.g.*, Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94, at *9 (citing this language).

101. *See supra* notes 45-54 and accompanying text.

102. *See supra* notes 12-19 and accompanying text.

103. *See supra* notes 12-19 and accompanying text.

nevertheless troublesome. If so, perhaps we need the private benefit doctrine to address these situations. This area holds more promise in identifying a separate private benefit doctrine, particularly since most of the cases in which private benefit is invoked involve economic benefits from contractual relationships with for-profits (joint ventures, service contracts and the like). It also offers some potential for actually defining a separate private benefit concept that is not already covered by other exemption rules.

On the one hand, it is hard to imagine a situation in which a charity *intentionally* diverts assets at less than market value to an outsider. If a charity enters into an economic transaction with someone who has no influence over the charity, there is simply no reason to believe that the charity would intentionally hand assets over to that person for less than full value. In fact, this principle of arm's-length transactions being presumed to be fair-market-value exchanges is a core principle of all of tax law,¹⁰⁴ born from general observations of human behavior and the administrative impossibility of policing every transaction. No one wants to be a "chump" taken advantage of by the other side. Ergo, no one is going to knowingly part with one's assets for insufficient value unless there is some relationship between the parties that signals the transaction is not at arm's-length. Accordingly, the notion that one would intentionally overpay or undercharge for services outside a context in which the recipient of the economic benefit has some kind of insider connection does not comport with either basic assumptions of our tax system nor with normal human economic behavior.

What is possible, however, is that the managers of a charity *negligently* "divert" assets to for-profit interests even in arm's-length transactions. This is the possibility recognized by Judge Posner at the end of his opinion in the *United Cancer Council* case when he opined that irresponsible management could result in private benefit.¹⁰⁵ That is, because of a lack of information or a lack of rigor in analyzing the benefits and costs of particular transactions, charities may engage in transactions with outsiders that either are economically inefficient or result in them paying too much for what they get or getting too little for what they give up—what I will call a failure to conserve assets for the benefit of the charitable class. Such

104. The classic definition of "fair market value" for tax purposes is the price on which a willing buyer and willing seller, each in possession of the relevant facts, agree. *See* Treas. Reg. § 1.170A-1(c)(2) (as amended in 2005); Treas. Reg. § 20.2031-1(b) (as amended in 1965); Treas. Reg. § 25.2512-1 (as amended in 1992); *see, e.g.*, *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184, 189 (Ct. Cl. 1954) (stating that fair market value of property received in exchange can be proven by reference to fair market value of property given up, since in an arm's-length exchange the two values "are either equal in fact, or are presumed to be equal").

105. *See supra* notes 68-71 and accompanying text.

a failure to conserve is bothersome, because the charity is wasting assets that should otherwise be used for charitable services—in effect, the charity is shifting some of the economic value from the various tax benefits we confer on exempt organizations (exemption, charitable contributions deduction, etc.) away from charitable services.

I believe this failure to conserve is most likely to arise in two separate circumstances outlined below, neither of which is specifically addressed by either the primary purpose rule or the private inurement/4958 regime. Suppose, for example, that we imagine a nonprofit hospital that has a community board and an open staff policy, treats Medicare and Medicaid patients, and provides free emergency treatment to the poor. These are the characteristics the IRS set forth in Revenue Ruling 69-545 for charitable exemption for a hospital.¹⁰⁶ But it so happens that this particular hospital conducts all its services via contract with for-profit entities. The emergency room is managed by Emergency Doctors, Inc.; patient records and billing are farmed out to Hospital Records Corp.; nursing services are provided by Nurses Clinic, Inc.; diagnostic and lab services are likewise in the hands of for-profit providers, and so forth.¹⁰⁷ All the contracts with these providers are negotiated at arm's length at fair market value, but of course the negotiated price includes a profit margin for each for-profit entity providing services to the hospital and its patients.

Although this hospital appears to meet all the requirements of charitable exemption set forth in Revenue Ruling 69-545,¹⁰⁸ the hypothetical raises a nagging question about why the hospital has chosen to provide all its services via contracts with for-profit firms. In essence, the question here is why we should permit exemption to fund the profit margin necessarily paid to the for-profit contractors as opposed to a direct service model where presumably that profit margin would be “saved” by the nonprofit and used instead to provide expanded services to the charitable class. In short, the evil here is not a conscious diversion of charitable assets, but rather a potential *failure to conserve* charitable assets for the benefit of the charitable class by entering into transactions that cause an unnecessary outflow of assets to non-charitable interests.

Similarly, one might imagine situations in which an exempt charity

106. See Rev. Rul. 69-545, 1969-2 C.B. 117, 1969 IRB LEXIS 176, at *1-2, *7; see also Colombo, *supra* note 31, at 480.

107. My hypothetical may not be far from the truth, at least if one believes the report of the Champaign County Board of Review recommending that the Illinois Department of Revenue revoke tax exemption for Carle Hospital in Urbana, Illinois. CHAMPAIGN COUNTY BOARD OF REVIEW, NOTES ON EXEMPT APPLICATIONS 11-12, <http://www.co.champaign.il.us/BOR/CARLE2004.pdf>. In this report, the Board of Review recommended that the Illinois Department of Revenue revoke property tax exemption from Carle Hospital based in part on its extensive contracts with for-profit groups to provide services to hospital patients. *Id.* at 10-11.

108. See Rev. Rul. 69-545, 1969-2 C.B. 117, 1969 IRB LEXIS 176, at *1-3, *7.

negligently fails to fully exploit the value of rights it has assigned to an unrelated for-profit entity. Suppose, for example, that an exempt nonprofit tissue bank enters into a long-term exclusive agreement to provide tissue to a single unrelated for-profit tissue processor.¹⁰⁹ The arrangement is at arm's length and therefore under general tax law presumptions, we would normally assume that it is at "fair market value." But the tissue bank has given up the right to exploit changes in the market by engaging in a long-term exclusivity agreement. It is possible in this case that the nonprofit is conferring a competitive advantage on the for-profit processor (in the form of a stable supply of tissue at a fixed price) and in the process failed to extract an above-market price (supra-normal profit) for the tissue justified by this competitive advantage. This situation, therefore, might also present a case in which the charity has failed to conserve charitable assets by giving up a valuable right (the right to freely exploit the future market for its goods) without full compensation. One might even imagine cases in which, because of such long-term "cozy" relationships, the nonprofit involved fails to engage in the hard bargaining with its long-term business associate that would result in the proper capture of these supra-normal profits.

Neither of these cases is adequately addressed by current doctrine. Both hypotheticals involve organizations that are routinely recognized as exempt charities. Neither appears to be subject to the inurement/4958 prohibitions: My hypothetical hospital is engaged in fair-market-value exchanges, which would not be subject to the private inurement/4958 regime, while my tissue processing hypo involves a contract with an outsider, and hence also is not subject to the inurement/4958 analysis. Yet both situations involve cases in which arguably a charity may not be appropriately conserving charitable assets for its charitable class.

The main problem with these observations at this stage, however, is

109. This example was inspired by the analysis in Robert A. Katz, *The Re-Gift Of Life: Can Charity Law Prevent For-Profit Firms From Exploiting Donated Tissue And Nonprofit Tissue Banks?*, 55 DEPAULL. REV. 943, 998-1004 (2006) [hereinafter Katz, *The Re-Gift of Life*]. Professor Katz suggests that under current law, the private benefit doctrine could be read to capture transactions in which directors of a nonprofit exempt tissue bank transfer tissue to a for-profit processor, because under the National Organ Transplant Act (NOTA) the exempt tissue bank is not permitted to capture the full value of the tissue transferred to a for-profit processor. *Id.* Ergo, the exempt tissue bank is benefitting the private interests of the for-profit processors, and arguably is doing so in a substantial way. Under my formulation, presumably this would no longer be a risk, since the directors of the charity would not be negligently failing to capture economic value, but rather simply following the law. *See id.* at 1003-04 (under Judge Posner's formulation, no private benefit would occur as a result of following NOTA); *see also* Robert A. Katz, *A Pig in a Python: How the Charitable Response to September 11 Overwhelmed the Law of Disaster Relief*, 36 IND. L. REV. 251, 264-65 (2003) [hereinafter Katz, *A Pig in a Python*] (noting that under Judge Posner's formulation of private benefit in the *United Cancer Council* case, private benefit occurs in a case in which the directors violate their duty of care and negligently waste nonprofit assets).

that they are potentially overbroad in two ways. First, exempt charities engage daily in private benefit transactions simply as a result of operating. They pay the for-profit telephone company and the for-profit electrical and gas utilities for service, send packages via for-profit UPS and Fed-Ex, hire for-profit janitorial services, etc., all of which confer economic benefits on for-profit entities and involve payment of a profit margin to that entity, and none of which disturbs us in the least. In some cases, the charity may enter into long-term exclusive dealings with these providers as well. So why shouldn't these transactions result in private benefit scrutiny? Or should they?

Perhaps the answer here lies in a sort of unstated presumption analysis. That is, we could say that exemption law presumes that these routine services do not involve a failure to conserve charitable assets because they could not be performed by the charitable entity itself more efficiently. We instinctively assume, probably correctly in virtually all these cases, that paying an electric utility for power is cheaper (or at least no more expensive) for a charity than trying to generate its own power even though the payment to the utility includes a profit margin for the utility. Utilities, we know, employ economies of scale that likely would be impossible for a single business to replicate. Charities generally have no expertise in power generation and no invested capital base for doing that. We might logically presume, therefore, that common, routine services provided by for-profit entities to charities have similar economies that would be difficult or impossible for a charity to replicate, and therefore arm's-length contracts for such services should not generally raise issues about failing to conserve charitable assets.

But when it comes to what I will call "core services" of the exempt organization (e.g., services that form the core primary charitable purpose, such as a hospital providing medical services to its patients, as opposed to buying electrical power to heat its building, or a tissue bank supplying tissue to a for-profit processor for the ultimate purpose of bettering the health of the community), the above presumption no longer seems reasonable. If the major purpose of a hospital is to provide health services to patients, we would expect the hospital itself to be as efficient in delivering those services as an outside provider. It is the hospital, after all, not the outside provider, that has the invested capital base and presumably some expertise in providing health services. Similarly, if a tissue bank enters into an exclusive contract to supply tissue to a single processor, we might logically ask why (if it were legal to do so¹¹⁰) the tissue bank is not "shopping the market" for its product in order to maximize revenue. Since

110. Current law in the form of the National Organ Transplant Act limits the ability of tissue banks to capture these revenues. See Katz, *The Re-Gift of Life*, *supra* note 109, at 952-55.

the tissue bank is intimately involved in the tissue market, we would expect them to have the relevant information necessary to fully exploit their “product” and use this information to their advantage. Thus, unlike the case with contracts for routine services, at least we should not *presume* that hiring a for-profit company to provide services to the hospital’s patients or entering into an exclusive arrangement with a for-profit tissue provider is more efficient or “better” in some way than hiring nurses directly or dealing with several processors (or non-profit processors). In fact, perhaps an opposite presumption is justified in these cases: That is, if core services are “outsourced” to for-profit enterprises or exclusive deals involving core services are entered into that may confer competitive advantages on a for-profit entity, we might presume that a charity is failing to conserve charitable assets.

This counter-presumption, however, raises the second overbreadth possibility. Certainly we could imagine situations in which for one reason or another the charity is justified in outsourcing core services or is justified in conferring an economic advantage on a for-profit as part of a business relationship. For example, perhaps the governing board of my hypothetical hospital made a detailed study of the costs of providing services directly versus outsourcing them, and concluded that outsourcing would actually save money while keeping quality constant. Or my hypothetical tissue bank might have done a study of the tissue market and reasonably believed that the price negotiated for its exclusive arrangement was preferable to the risk of a downward price movement in the tissue market over the term of the exclusive agreement. If the board of either of my hypothetical charities made such a considered judgment, then presumably there is no failure to conserve charitable assets (or at least tax-exemption law should not second-guess such a considered judgment under the circumstances).

B. *Summary: The Resulting “Failure-to-Conserve” Test*

We can now gather the above rationale to fashion a doctrinal test for private benefit. If we view the evil that the private benefit doctrine tries to prevent as a negligent failure to conserve charitable assets, then the concept seems worthwhile because it operates in an area that current doctrine fails to capture. As noted above, neither the primary purpose analysis nor the inurement/4958 regime appears to cover “what’s wrong” with my hypothetical scenarios; ergo a separate concept that prohibits this potential evil seems appropriate.

This “failure to conserve” analysis could in theory apply to any transaction in which a charity contracts for service with a for-profit entity (since all such transactions involve the payment of a profit margin to the for-profit), but common sense tells us that in routine transactions for incidental services, such contracts are in fact justified on efficiency

grounds. As a matter of administrability of the tax laws, then, we should not apply private benefit analysis to such transactions. Instead, private benefit analysis should come into play primarily when a charity contracts with a for-profit entity for core services—that is, in situations in which an exempt entity outsources the delivery of core services to its charitable class, or situations in which the exempt entity enters into an economic arrangement with a for-profit involving core services and the arrangement arguably grants a competitive advantage to the for-profit. In these cases, where we legitimately can be suspicious of the economic efficiency of outsourcing such services or entering into competitive advantage arrangements, the concept of failing to conserve charitable assets is most in play.

Of course, the charity should be given the chance to rebut this suspicion by showing that the economic arrangements with outsiders for these core services are in fact a more efficient or “better” way to deliver services to the charitable class. Accordingly, if the charity can make a convincing case that it fully considered the options and reached a reasonable conclusion that its contractual arrangements were a better way to serve its charitable purpose, then the arrangements should be permitted to stand. In other words, in circumstances where we might legitimately view a particular economic transaction with suspicion, the charity should be required to provide a reasonable justification for why the transaction is in the best interests of serving the charitable class.

The next question, then, is what behavior should be sufficient to meet this “reasonable justification” standard. One possibility would be to import the state-law duty of care into this definition, and simply tie the federal concept of private benefit to the state charity law concept of duty of care—that is, the federal tax inquiry would be whether the transaction in question had violated state-law standards for the duty of care. Under this hypothesis, the reasonable justification would simply be a successful defense that the board had not violated this duty. However, for reasons of consistency across jurisdictions and the fact that the state-law duty of care might not require the sort of due diligence I conceive for this issue,¹¹¹

111. The duty of care, of course, covers all sorts of board-level decisions, and the state law surrounding the standards for the duty of care is still somewhat in flux. Marion Fremont-Smith reports that as of the beginning of 2003, forty-three states had codified a standard for the duty of care, and over half of those states had adopted the definitions in the ABA’s Revised Model Nonprofit Corporation Act (RMNCA) promulgated in 1987. MARION R. FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAWS AND REGULATION* 207 (2004). The American Law Institute also is currently engaged in a project on nonprofit law that may further refine the duty of care at the state level. *See* *PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS* § 315 (Council Draft No. 4, 2006). Obviously, federal tax law needs a single standard of behavior since the federal tax law is applicable to organizations across all state jurisdictions; moreover, I contemplate that because of what I view as an “enhanced” risk that

federal tax law should define its own version of reasonable justification for this purpose. In general terms, one could envision using the same sort of approach used in the salary safe-harbor provision of the regulations under § 4958, requiring a board to use comparable salary data and to document the basis for its decision.¹¹² Applying this approach to the failure to conserve test, the reasonable justification would need to be based upon relevant comparable data and practices by similar exempt charities, and the organization would have to document a rationale for why it believed the transaction “improved” services to the charitable class. In my hospital hypothetical, for example, the relevant data likely would consist of a comparison of the costs and quality of providing services internally versus outsourcing such services. My hypothetical tissue bank might document the volatility in the tissue market that would justify a long-term arrangement at a stable price, or show that the price in the long-term deal was higher than that provided by the “spot market” over some average period to illustrate that the exempt organization had fully considered the value of the economic advantage it was granting to the for-profit processor.

C. Matching the “Failure-to-Conserve” Rationale to Existing Doctrine

Now that I have outlined the failure-to-conserve rationale, the paradigm situations in which it might occur, and the resulting doctrinal test for private benefit in these circumstances, the next logical questions are how would the proposed affect existing precedent on the application of the

charities are failing to conserve assets in the paradigm transactions I consider above, we might well demand somewhat more diligence for directors than would be required by the “ordinarily prudent person” standard of the RMNCA.

112. Treas. Reg. § 53.4958-6(a) (2006). Exempt charities that follow the safe-harbor provision receive a benefit in that the burden of proof for noncompliance shifts to the IRS. There has been some suggestion that this safe harbor may be too lenient. In 2005, for example, the Joint Committee on Taxation proposed deleting the safe-harbor and substituting a “due diligence” standard that would keep the burden of proof on the charity to explain how it approved a salary in certain circumstances. JOINT COMM. ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, JCS-02-05, at 254-69 (2005). I would not apply the burden-shifting provision of Treas. Reg. § 53.4958 to my analysis, however, because I view the kinds of paradigm transactions I have identified (“outsourcing” core services or using core services as the basis for conferring a competitive advantage on a for-profit) as inherently suspect. Ergo, the charity should retain the burden of proving that these transactions are in the best interests of the charitable class. Instead, I would view a charity’s reliance on data and written justification as a sort of prima facie case, which the IRS could rebut by showing contrary evidence indicating that the charity’s reliance on the data or its justification were manifestly unreasonable under the circumstances. I use “manifestly” here because hindsight is always 20/20, and we should be careful to give the governing board of a charity the benefit of the doubt concerning the reasonableness of their conclusions when we are judging them at some later point than when the decision was made.

private benefit doctrine, and how might it apply to various “troublesome” scenarios in which the IRS has used private benefit as a policing tool.

1. “Incidental” Private Benefit and the Transactional Approach

Perhaps the first thing to note is that with its focus on core services, the failure-to-serve rationale fits well with the IRS’s declaration in General Counsel Memorandum 39,598 that incidental private benefit is not a concern.¹¹³ Focusing on core services would exempt from private benefit analysis all truly routine, incidental transactions required by daily operations under the theory that these transactions present virtually no possibility of a failure to conserve assets. Doing this, moreover, is probably an administrative necessity anyway, since this avoids saddling charities and the IRS with the need to review and justify literally thousands of common business transactions. On the other hand, all transactions involving core services (e.g., a hospital hiring a for-profit doctors group to cover emergency room medical services, a nonprofit organization doing a low-income housing deal via a partnership with for-profit partners) would be subject to the analysis presented above and would require the charity to have a reasonable justification for the transaction—or in other words, no transaction dealing with core services would be considered incidental for this purpose (for example, as I discuss below, ancillary joint ventures would not be exempt from this analysis if the joint venture involved core services).

But what of the IRS’s “transactional” approach to private benefit (e.g., the assertion that a single private benefit transaction will endanger exempt status)? As much as I have previously criticized the transactional approach, if private benefit is limited as I have outlined in this article, then it makes some sense to use a transactional analysis here, just as we have used it for years in the private inurement realm. That is, if a charity really is guilty of negligently “wasting” charitable assets (after having given the charity “fair warning” that these core services transactions will be specially scrutinized and allowing them to build their justification case), then there is a reason to consider revocation of exemption. Whatever your theoretical bent in justifying exemption, a charity that is not appropriately conserving its assets for use on the charitable class should not be given preferential tax treatment. As a practical matter, moreover, the IRS can enter into closing agreements to avoid revocation in appropriate cases, just as it did for private inurement transactions prior to the adoption of I.R.C. § 4958.¹¹⁴

113. See *supra* notes 41-43 and accompanying text.

114. See, e.g., Bernadette M. Broccolo & Michael W. Peregrine, *Bad Doctor Deals Place Hospitals At New Risk: Part I—The Hermann Hospital Closing Agreement*, 10 EXEMPT ORG. TAX

2. Joint Ventures (Particularly in Health Care and Low-Income Housing)

The use of private benefit as a tool to police transactions involving core services necessarily requires me to revise my past position that joint venture transactions should be subjected *only* to primary purpose/commerciality/unrelated business income analysis.¹¹⁵ That analytical paradigm should still be the first step in analyzing joint-venture transactions, but if the exempt venturer survives this initial stage and the venture involves core services, I would bring the failure-to-serve analysis into play as a second analytical step. As indicated below, as a practical matter, my analysis would reach the same end results as the IRS has reached in its recent rulings (though perhaps not the same result as in some older rulings), and would also provide a coherent analysis for private benefit that would be applicable across all joint ventures, ancillary or not.

Let's start with the whole-hospital joint venture as set forth in Revenue Ruling 98-15.¹¹⁶ I begin the analysis of these transactions with the primary purpose/commerciality doctrine, which asks whether the exempt venturer is still engaged primarily in a charitable activity.¹¹⁷ In the case of a whole-hospital joint venture, this question usually is answered by asking whether the joint venture itself is a charitable activity.¹¹⁸ If the exempt venturer in these cases has no continuing charitable program (other than being a partner in the hospital venture), and the joint venture itself is not charitable, the analysis is over, because the exempt entity is primarily engaged in an unrelated commercial activity.¹¹⁹ Thus, in these cases, private benefit never becomes an issue at all. Analytically, this approach is radically different than the fixation on control and private benefit that pervades Revenue Ruling 98-15, although the ultimate result would be the same (i.e., no exemption for the nonprofit venturer).¹²⁰

REV. 1341 (1994) (discussing IRS closing agreement with Hermann Hospital involving private inurement and private benefit issues).

115. John D. Colombo, *A Framework for Analyzing Exemption and UBIT Effects of Joint Ventures*, 34 EXEMPT ORG. TAX REV. 187, 189 (2001). See Mirkay, *supra* note 2, at 60-65. If the IRS will adopt the approach in this article to private benefit doctrine, I promise to walk down Pennsylvania Avenue in sackcloth and ashes as a sign of my repentance.

116. Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94, at *1.

117. Colombo, *supra* note 115, at 189.

118. *Id.* at 189-90.

119. The venturer is deemed to be engaged in the underlying activity of the joint venture. Rev. Rul. 98-15, 1998-1 C.B. 718, 1998 IRB LEXIS 94, at *16-17. Hence if the venture itself is not a charitable activity, the venturer should be viewed as simply conducting a for-profit business. If the venturer has no other substantial charitable activity, it fails the primary purpose test. Colombo, *supra* note 115, at 190.

120. See Colombo, *supra* note 115, at 191-93. As I have observed in the past, the IRS's

Suppose, however, that we move to the case of an exempt organization whose charitable purpose is to provide low-income housing. This exempt organization acts as the general partner of limited partnerships with for-profit investors who essentially receive nothing in return except an allocation of the low-income housing tax credit provided by § 42 of the Code.¹²¹ Currently, this area is a complete mess. The IRS appears schizophrenic about permitting nonprofit organizations to engage in low-income housing partnerships, at once recognizing the charitable purpose of such arrangements and at the same time invoking private benefit analysis (and the control test) as a limitation on such arrangements that essentially prohibit exempt partners from structuring the partnership in ways demanded by the market.¹²²

Under my analysis, one still begins with the primary purpose issue. In this case, however, one might conclude that the venture itself (providing low-income housing) is a charitable activity by virtue of the fact that the venture itself is engaged in relief of the poor.¹²³ But even if that is true, because the nonprofit organization has entered into a contract (the partnership agreement) with for-profit entities (the investors in the partnership) to provide core services (create low-income housing), we would invoke the private benefit analysis and ask the nonprofit to provide

fixation on control in these cases is misplaced; control should be a factor in determining whether the joint venture itself is charitable, but the role of control ends there. Once we have determined whether the joint venture is charitable, the analysis shifts to a “primary purpose”/UBIT analysis. *Id.* at 191-92.

121. See I.R.C. § 42 (2000).

122. See, e.g., Jerry O. Allen & Alan D. Duffy, *Solving the Low-Income Tax Credit Housing Partnership Dilemma*, 49 EXEMPT ORG. TAX REV. 319, 319-20, 323 (2005); J. Christine Harris, *Tax-Exemption And Low-Income Housing Ventures: Irreconcilable Differences?*, 47 EXEMPT ORG. TAX REV. 329, 331 (2005); Harris, *supra* note 81, at 21; Michael I. Sanders & Celia A. Roady, *EO Practitioners Suggest Way To Expedite Exemptions For Low-Income Housing Orgs.*, 37 EXEMPT ORG. TAX REV. 127, 127-28 (2002). In late April 2006, the IRS released additional guidance for charitable organizations engaging in low-income housing partnerships that sought to ameliorate some of these criticisms and seems to support the argument in the text below that such partnerships are usually the best, if not only, vehicle for pursuing the financing necessary to bring low-income housing projects to fruition. See, e.g., Michael I. Sanders & Jerome A. Breed, *IRS Issues Guidance for Nonprofit Organizations Involved in Low-Income Housing*, 52 EXEMPT ORG. TAX REV. 263, 263 (2006); Memorandum from Joseph Urban, Acting Director, EO Rulings and Agreements, Internal Revenue Service to Manager, EO Determinations (Apr. 25, 2006), available at <http://www.irs.gov/pub/irs-tege/urbanmemo42406.pdf>.

123. The IRS has provided guidelines in Rev. Proc. 96-32 for determining when a low-income housing project should be considered a charitable activity. Rev. Proc. 96-32, 1996-1 C.B. 717, 1996 IRB LEXIS 152, at *1-7. If the partnership adheres to these guidelines, then one might conclude that the partnership activity itself is a charitable activity, much as one might conclude that a hospital operated by an exempt/for-profit partnership would be a charitable activity if the hospital met all of the requirements of Revenue Ruling 69-545, as re-interpreted by the Tenth Circuit in *IHC Health Plans v. Commissioner*, 325 F.3d 1188, 1195-98 (10th Cir. 2003).

reasonable justification for its transaction. This should not be hard to do. If the transaction is properly structured as an arm's-length deal with the investors, the reasonable justification will most likely be that the partnership is the most economically efficient vehicle for the nonprofit to execute its charitable purpose, since other financing will either be unavailable or more expensive because of the risk inherent in low-income housing.¹²⁴ In other words, there is no way for the exempt organization to better conserve charitable assets than by using the partnership financing vehicle to accomplish its exempt purpose. On the other hand, if the exempt venturer "gives away the store" in the partnership agreement by, for example, bearing a disproportionate amount of the economic risk in the venture, then one might legitimately invoke the private benefit limitation for this failure to conserve charitable assets.

When it comes to ancillary joint ventures, things would get modestly more complicated than they may be today. If, in fact, the ancillary joint venture ruling is an acknowledgment by the IRS that no private benefit issues are raised in economic transactions that involve "insubstantial" services, then the proposed failure-to-conserve analysis might actually complicate life for exempt entities. The reason for this is that many ancillary partnership transactions involve core services. Certainly a hospital that opens an outpatient surgery center in a joint venture with doctors is providing core services (e.g., health services to patients) through an economic arrangement with for-profit partners. Moreover, transactions such as the "revenue stream" partnerships involved in General Counsel Memorandum 39,862 are exactly the ones that should raise some eyebrows, because the charity (the hospital) is giving up a future revenue stream (a significant charitable asset) in a transaction with for-profit investors.¹²⁵ Accordingly, it seems appropriate to require the charity in these cases to justify the transaction on the basis that it permits an expansion, improvement or (in appropriate circumstances) the maintenance of services to the charitable class.

In most of these cases, however, I would expect that the exempt organization would have little trouble meeting the reasonable justification requirement. Ancillary partnerships almost always have the purpose of either keeping current services intact or expanding services to the charitable class, and almost universally are undertaken in order to accomplish those goals with minimal financial risk to the charitable entity. Hospitals, for example, undertake ancillary partnerships with doctors in order to insure that the facilities are fully utilized and that the doctors have

124. See Allen & Duffy, *supra* note 122, at 321 ("Equity financing is an important component of the financing package.").

125. For a discussion of this memorandum, see *supra* notes 55-59 and accompanying text.

a direct financial stake in the success of the services.¹²⁶ The ancillary partnership ruling (Revenue Ruling 2004-51) itself involved a situation in which a university proposed to expand services to students via a distance-learning joint venture.¹²⁷ It is highly unlikely, therefore, that these transactions generally suffer from a failure to conserve charitable assets (in fact, just the opposite is true).

In one aspect, moreover, the failure-to-conserve analysis would be more generous than past IRS precedents: It would overturn the IRS's position in General Counsel Memorandum 39,862 that entering into transactions to improve revenues or to retain relationships with doctors violates the private benefit doctrine.¹²⁸ If, in fact, an exempt hospital can justify a revenue stream joint venture as a means of improving facility utilization (and hence improving the bottom line of the hospital and thus conserving more assets for use on the charitable class) or as a necessary method of keeping physician affiliations (without which the hospital would fail economically, leaving no assets available for use for the charitable class), then I see no reason not to let these arrangements continue.

To summarize, I would apply the failure-to-conserve analysis equally across all types of joint ventures, be they whole or ancillary. While this approach would impose somewhat more scrutiny on ancillary partnerships than was undertaken in Revenue Ruling 2004-51 (at least in cases where the ancillary partnership involves core services), the advantage would be that the analysis of private benefit issues would be consistent across all joint venture transactions, thus avoiding the need to classify them into ancillary or non-ancillary categories, and hence giving the IRS an escape from the unpleasant corner it may have found itself painted into with the current private benefit analysis. Instead, the only question one would ask from a private benefit standpoint with respect to joint ventures is whether the venture involves core services. At the same time, charities would benefit from a somewhat broader view of the appropriate justifications for these transactions,¹²⁹ giving them more flexibility to arrange their economic affairs in a way that truly preserves the maximum assets for serving charitable beneficiaries.

126. See 1 MANCINO, *supra* note 56, at § 19.04.

127. Rev. Rul. 2004-51, 2004-1 C.B. 974, 2004 IRB LEXIS 201, at *1-2; see *supra* notes 79-81 and accompanying text.

128. See *supra* notes 55-59 and accompanying text.

129. That is, hospitals could do these transactions solely to increase utilization rates or improve the hospital's revenues, a rationale that the IRS rejected as insufficient in General Counsel Memorandum 39,862.

3. Credit Counseling and Down-Payment Assistance

The most recent examples of the IRS's use of the private benefit doctrine in dealing with exempt credit counseling and down-payment assistance organizations appear to fit my analytical model. In the credit counseling cases, my implementation of private benefit almost certainly would reach the same results that the IRS has reached. The credit counseling agencies are a classic case of outsourcing core (and not-so-core) services to for-profit affiliates, who then profit from the fees paid to them by the agency or directly by the agency's charitable beneficiaries.¹³⁰ This profit flow is similar to my original hypothetical of the hospital that outsources nearly all its services. Because I doubt that the agencies could come up with a compelling explanation for why these complex outsourcing arrangements are more efficient in educating their beneficiaries about debt management, the IRS conclusion in the Chief Counsel's memo discussed earlier—that the economic arrangements between credit counseling agencies and the "back-office service providers" violate the private benefit proscription—likely would hold true under the analytical model I suggest in this paper.

With respect to the down-payment assistance organizations, my analysis requires a more rigorous rationale than what the IRS publicly presented in Situation 2 of Revenue Ruling 2006-27.¹³¹ Recall that the IRS's main problem in Situation 2 was that the organization in question used a circular cash flow to help its beneficiaries—that is, the money to provide down-payment assistance came from the seller of the property.¹³² According to the IRS, this meant that the exempt organization really was more interested in facilitating private housing sales than helping a charitable class, thus violating the private benefit doctrine.¹³³ A circular cash flow standing alone, however, does not present a good rationale for revoking exemption. If all that was happening in these cases is that the exempt organization was providing a conduit to connect needy families with housing sellers anxious to market their goods, it would be hard to see the problem with these transactions. After all, the charitable beneficiaries would be served in these cases by getting the down-payment assistance and the sellers presumably would get market price for their housing. Who cares if the money to make the arrangement work comes from the seller? Indeed, one doubts that the IRS would have a problem with the Bill and Melinda Gates Foundation making a \$1 million grant to a school to help finance the acquisition of computers that just happen to run the Microsoft

130. See *supra* notes 84-87 and accompanying text.

131. Rev. Rul. 2006-27, 2006-21 I.R.B. 915, 2006 IRB LEXIS 207, at *3.

132. See *supra* notes 86-88 and accompanying text.

133. See Rev. Rul. 2006-27, 2006-21 I.R.B. 915, 2006 IRB LEXIS 207, at *18.

Windows operating system.

But some investigation of the background of this ruling reveals that the real concern is not the circular cash flow per se; rather it is that in these cases the charitable organization is being used as a “front” to funnel charitable beneficiaries to sellers in order to increase the sellers’ market share and hence profits from their sales; according to the General Accounting Office, these circular transactions often resulted in the charitable beneficiaries paying 2-3% more for a house than in a non-assisted transaction.¹³⁴ In other words, in these cases the charitable organization has contractual agreements with for-profit entities in which the charitable organization agrees to exploit its beneficiaries in order to enhance the revenues of its for-profit partners. These transactions, therefore, fit the “exclusive dealing” paradigm in which the charity essentially transfers some portion of the value of its relationship with its charitable beneficiaries to its for-profit partners—that is, the charity contractually agrees to “guide” its beneficiaries into transactions that produce a supra-normal profit for the for-profit seller. In short, the charity is giving up value that should be preserved for the charitable class. Under the approach outlined in this paper, unless these organizations could come up with a persuasive rationale for why steering their charitable beneficiaries into transactions that will cost them more than the normal market value is good for society, they should not be exempt.

This analysis shows that one of the benefits of my approach to the private benefit doctrine is that it avoids sloppy analysis. Circular cash flows are not necessarily bad; however, in these cases the problem is with transactions that may extort value from the charitable class in favor of for-profit entities. It is that extortion that presents the private benefit problem, not the circular cash flow, and the IRS’s analysis in Revenue Ruling 2006-27 would be stronger if it acknowledged this fact.

4. Non-Economic Benefits: *American Campaign Academy*

Suppose that Intel Corporation decides tomorrow that there is a woeful lack of computer engineers skilled in applied circuit design of the type that Intel most needs. To remedy this situation, Intel donates a wad of cash to fund a new educational organization, the Santa Clara Graduate School of Computer Circuit Design. The curriculum of the school is set up specifically to train computer engineers in the applied skills that Intel

134. See, e.g., Internal Revenue Service, *IRS Targets Down-Payment-Assistance Scams; Seller-Funded Programs Do Not Qualify As Tax Exempt*, IR-2006-74, May 4, 2006, <http://www.irs.gov/newsroom/article/0,,id=156675,00.html>; GOV’T ACCOUNTABILITY OFFICE, MORTGAGE FINANCING: ADDITIONAL ACTION NEEDED TO MANAGE RISKS OF FHA-INSURED LOANS WITH DOWN PAYMENT ASSISTANCE 22 (2005), <http://www.gao.gov/highlights/d0624high.pdf>.

needs. One of the three members of the board of this new entity is a senior Intel computer engineer, another is a free lance engineer who often consults with Intel, and the third is a local community leader.

Many of the professors are former or current Intel engineers and it so happens that most of the graduates of this new school are employed by Intel (not surprising, given the objectives and curriculum of the school). But not all the graduates are employed by Intel, and there is no agreement between the school and Intel under which Intel gets an unfair “first crack” at school graduates. In short, there is no contractual or economic arrangement that might be a case of a charity “under-charging” for giving a competitive advantage to a for-profit enterprise, but neither is there any question that the school in fact benefits Intel by training engineers in precisely those skills most needed by Intel.

Should my hypothetical school be tax-exempt? In this scenario, what exactly could be the complaint to bar the school from tax exemption? Education by its nature benefits private interests; Silicon Valley certainly benefits from the close proximity of Stanford, but no one suggests it should lose tax exemption as a result. Many technical and professional training programs serve as “pipelines” to particular employers; a large proportion of the top graduates of my law school, for example, end up being employed by a dozen large Chicago law firms. Does that make the University of Illinois College of Law guilty of prohibited private benefit (legally irrelevant, since we are exempt as part of state government rather than under § 501(c)(3), but an interesting question nonetheless)? One might argue that training individuals in skills that primarily benefit a single employer (as opposed to multiple employers) is not charitable. But that certainly is not the definition of “educational” in the Treasury Regulations, which provide that “instruction or training of the individual for the purpose of improving or developing his capabilities” is charitable.¹³⁵ Moreover, even a first-year law student would recognize the “slippery slope” problems inherent in such a line—are two employers enough? Three? Four?

The facts of my Intel hypothetical mirror the actual facts of *American Campaign Academy*,¹³⁶ and I have yet to figure out why the case was decided as it was (maybe it was a misplaced view that the whole operation somehow violated the prohibitions against political campaign activity, which simply was not true¹³⁷). The notion that ill-defined secondary

135. Treas. Reg. § 1.501(c)(3)-1(d)(3)(i)(a) (2006).

136. *Am. Campaign Acad. v. Comm’r*, 92 T.C. 1053, 1055-61 (1989).

137. Judge Nims complained in his opinion about the failure of ACA to operate in a “nonpartisan” manner, *id.* at 1070-71, but the IRS conceded that ACA did not violate either the lobbying or campaign activity restrictions, *id.* at 1063. Charitable organizations do not have to be “nonpartisan” in the sense of being politically neutral in everything they do; they only have to avoid

benefits should override the very real primary educational purpose of ACA did not have any basis in the law at the time the case was decided, and still makes no sense. ACA graduates were not required to work for Republicans and some, apparently, did not (the opinion notes that at least one graduate worked for a candidate overseas).¹³⁸ Even if one would view training that primarily benefitted a single employer as incompatible with tax exemption, in the ACA case the students went to work for multiple employers (individual candidates, not the Republican Party as an entity).¹³⁹ The decision fares no better under my “failure-to-serve” rationale. Without some economic arrangement that confers a competitive advantage to the Republican Party beyond the advantage conferred by simply training students with the appropriate skills (an advantage conferred on all employers by all educational organizations), it is difficult to see how the fact that ACA graduates were overwhelmingly employed by Republican candidates involved some failure to conserve charitable resources. ACA could not have “charged” the Republican Party or Republican candidates a higher price for its services, since ACA was not providing any services to the Republican Party or candidates.¹⁴⁰ Accordingly, if one adopts the “failure-to-serve-assets” rationale for the private benefit doctrine, *American Campaign Academy* almost certainly is wrongly decided.

participating in political campaigns or doing more than an insubstantial amount of political lobbying. See I.R.C. § 501(c)(3) (2000); Treas. Reg. § 1.501(c)(3)-(1)(c)(3) (defining “action” organizations).

138. *Am. Campaign Acad.*, 92 T.C. at 1060.

139. *See id.*

140. I might approach this case differently if there was some contractual arrangement between ACA and the Republican Party that required ACA to supply the Republican Party with a certain number of qualified campaign operatives or permitted the Republican Party to have some kind of special access to graduates that was denied to other potential employers, or if ACA hired only Republican National Committee members as its faculty and licensed only Republican campaign literature from the National Committee for use in its classes. In such a case, one might argue that ACA had improperly “outsourced” core services (teaching and training materials) or inadequately charged for a competitive advantage (exclusive access to students). Compare, for example, my analysis of Example 3 in the IRS’s proposed regulations on private benefit in the text *infra* at notes 161-65. Despite my views of the ACA case, I admit that one could view the overall relationship between ACA and the Republican Party as being highly “incestuous,” particularly given the makeup of the governing board of ACA and the predominance of Republicans on its admissions committee. I do not discount the fact that if my test for private benefit were used, additional fact development in the case might have revealed that there were “side deals” in place between ACA and the Republican Party that might have conferred a competitive advantage on the Party. This is precisely why my approach to private benefit is needed; rather than get by with vague assertions of too cozy a relationship between a charity and a for-profit entity, the IRS should be forced to make at least a prima facie case why the relationship has stripped charitable beneficiaries of resources. These facts might or might not have existed in the ACA case; we will never know, since the current state of private benefit doctrine permits the IRS to make sloppy accusations with little, if any, rigorous analysis.

5. *United Cancer Council*

As noted above, the failure-to-serve approach is rooted in Judge Posner's observation in *United Cancer Council* that the private benefit doctrine might cover a situation in which UCC's board had overpaid for fundraising services.¹⁴¹ While the focus of my approach on core services is narrower than the general common law duty of care, and while I would fashion a tax-law specific definition for reasonable justification that might be somewhat more demanding of board action than current state law,¹⁴² the essential concepts are similar: Tax exemption law should frown on transactions in which boards do not diligently conserve their assets for use on the charitable class.

Though the *United Cancer Council* case was settled, and hence never retried on the private benefit point, one could easily trace how the case might be analyzed under my failure-to-serve approach. UCC's entering into an exclusive arrangement with a for-profit fundraiser would raise private benefit concerns inasmuch as fundraising is not a routine business transaction and directly affects UCC's ability to engage in core services for its charitable beneficiaries. This in turn would then trigger the requirement that UCC have a reasonable justification for why it entered into a contract that gave the fundraiser over 90% of the gross amount raised. Because the case was settled, the answer is unclear—but I note that a variety of charities have far lower fundraising costs,¹⁴³ and therefore it is not unreasonable to presume that UCC could have done better (and thus conserved more assets for its charitable purpose) either by taking fundraising in-house or by contracting with a different outside fundraiser.

6. "Excessive" Benefits to the Charitable Class: Disaster Relief and Private Benefit

One of the more vexing problems recently faced by the IRS and charities is how to handle disaster relief in a manner consistent with charitable purposes. Disaster relief has long been recognized as a charitable purpose,¹⁴⁴ but after the Oklahoma City bombing and again after the 9/11 attacks, questions arose about the ability of charities to make economic grants (in the form of cash or property) to individuals who have

141. See *supra* notes 68-71 and accompanying text.

142. See *supra* note 111.

143. See, e.g., Association of Fundraising Professionals, *Fundraising Costs: Size, Age Matter*, AFP EWIRE, July 18, 2003, http://www.afpnet.org/ka/ka-3.cfm?folder_id=2345&content_item_id=12886 (recent study of fundraising costs showed average costs to be \$.24 on every \$1).

144. See Katz, *A Pig in a Python*, *supra* note 109, at 266-67; Catherine E. Livingston, *Disaster Relief Activities of Charitable Organizations*, 35 EXEMPT ORG. TAX REV. 153, 153 (2002).

suffered from a disaster, particularly if such grants were not to those traditionally classified as “poor” or under some other specific financial need.¹⁴⁵ At one point, the IRS had suggested that such grants might violate the private benefit doctrine, stating in a letter to Oklahoma City charities after the bombing there that although one did not have to be poor to be eligible for disaster relief, “an outright transfer of funds based solely on an individual’s involvement in a disaster or without regard to meeting the individual’s particular distress or financial needs would result in excessive private benefit.”¹⁴⁶ After the 9/11 attacks, however, the IRS issued Notice 2001-78 stating that it would treat payments made by charities to disaster victims and their families as related to the charity’s exempt purpose as long as such grants were made “in good faith using objective standards.”¹⁴⁷ Nevertheless, the private benefit issue raised enough concern that after 9/11 Congress enacted legislation that specifically provided that cash grants to 9/11 victims would be considered as made for an exempt purpose, essentially removing the private benefit analysis from payments made for 9/11 disaster relief.¹⁴⁸ The current IRS position on disaster relief, however, appears to have returned to the proposition that the charity must make some kind of “needs” assessment when appropriate and to document the basis for its grants.¹⁴⁹

In two articles published in 2003, Professor Robert Katz argued that both state charity law and the federal tax private benefit doctrine should be read to prohibit charities from conferring excessive financial benefits on their beneficiaries in the context of disaster relief.¹⁵⁰ Although this situation does not fall squarely into one of my two paradigms identified above, using the failure-to-serve rationale for private benefit validates Professor Katz’s conclusions; it also confirms both that the IRS approach of requiring some needs assessment and documentation is exactly correct and that the legislative approach to the 9/11 disaster was too broad.¹⁵¹

145. JAMES J. FISHMAN & STEPHEN SCHWARZ, *TAXATION OF NONPROFIT ORGANIZATIONS* 145-46 (2d ed. 2006).

146. Livingston, *supra* note 144, at 154 (quoting letter from Richard Hanson, Internal Revenue Agent, to John H. Trudgeon); see Katz, *A Pig in a Python*, *supra* note 109, at 286-87.

147. I.R.S. Notice 2001-78, 2001-2 C.B. 576, 2001 IRB LEXIS 488.

148. Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, § 104, 115 Stat. 2427, 2431 (2002). See FISHMAN & SCHWARZ, *supra* note 145, at 147; Katz, *A Pig in a Python*, *supra* note 109, at 292-93; Livingston, *supra* note 144, at 154.

149. INTERNAL REVENUE SERVICE, PUBLICATION 3833: DISASTER RELIEF 7-9 (2005), available at <http://www.irs.gov/pub/irs-pdf/p3833.pdf>.

150. Katz, *A Pig in a Python*, *supra* note 109, at 331-32; Robert A. Katz, *Too Much of a Good Thing: When Charitable Gifts Augment Victim Compensation*, 53 DEPAUL L. REV. 547, 562 (2003) [hereinafter Katz, *Too Much of a Good Thing*].

151. See Katz, *A Pig in a Python*, *supra* note 109, at 331-33 (providing a much more thorough analysis of the 9/11 situation that generally agrees with the observation in the text).

Providing grants and other assistance to disaster victims certainly would come within the scope of core services that a charity would provide to beneficiaries and hence would invoke my failure-to-serve analysis. The question that this analysis poses is how a charity can best conserve charitable assets for use across the charitable class. If the charitable class is a set of disaster victims, a charity should make some reasonable effort not to over-compensate individual victims, since doing so wastes charitable assets that might be used for other victims (or other disasters). As a result, charities in these situations should adopt a set of guidelines that are geared toward making sure individual victims are not overcompensated at the expense of other victims.¹⁵² Needs assessment and documentation of the basis for the relief grant should satisfy us that the charity is not “negligently” making overcompensatory grants to individuals, and thus would satisfy the failure-to-serve analysis.

7. The Proposed Regulations Examples

Finally, we should compare the failure-to-serve rationale with the examples the IRS has presented in the new proposed regulations cited in the introduction.¹⁵³ The first example is an organization whose purpose is to trace the genealogy of a single family.¹⁵⁴ This example, which concludes that the organization fails the private benefit analysis, is simply a restatement of the classic common-law version of private benefit that relates to the size of the charitable class.¹⁵⁵ While I have no objection to using private benefit in this manner, it creates unnecessary confusion when a single concept such as private benefit is used to describe two very different substantive analyses. For purposes of clarity, I would prefer, therefore, that the IRS eliminate this as an example of private benefit and instead use it as an example of a failure of charitable purpose (i.e., the

152. For example, Gene Steuerle has suggested that charities in this situation need not “operate like ships in uncharted waters” and should take into account issues of progressivity (i.e., providing progressively more relief to the less economically-well off) and horizontal equity (i.e., making sure that victims in similar economic circumstances receive similar assistance). Gene Steuerle, *Charities and Disaster Relief*, 35 EXEMPT ORG. TAX REV. 159, 159 (2002). In *Too Much of a Good Thing*, Professor Katz distinguished between the objectives of tort law and charity law, noting that while tort law strives to make a person whole, there is nothing inherently charitable about that objective, and that by contrast, “[l]oss alleviation ceases to be charitable . . . if it disburses more cash than necessary to relieve the victim’s financial distress.” Katz, *Too Much of a Good Thing*, *supra* note 150, at 549. Accordingly, the charitable purpose of disaster relief must necessarily focus on simply relieving financial distress of victims, not granting them compensatory tort damages.

153. Standards for Recognition of Tax-Exempt Status if Private Benefit Exists or If an Applicable Tax-Exempt Organization Has Engaged in Excess Benefit Transactions(s), 70 Fed. Reg. 53,599 (proposed Sept. 9, 2005) (to be codified at 26 C.F.R. pts. 1, 53).

154. *Id.* at 53,601.

155. *Id.*

organization in question has no charitable purpose, because a charitable purpose requires serving a broad charitable class).

The second example deals with an “art museum” that displays and sells only art created by “a group of unknown but promising local artists.”¹⁵⁶ The organization has an independent board, which presumably selects the works for display (although the example does not specifically state this), but artists set their own prices for the art, and the organization receives a 10% “commission” from sales to cover its operating expenses.¹⁵⁷ The example concludes that the direct benefits (the receipt of 90% of the sales price) of the art constitutes an impermissible private benefit.¹⁵⁸

While I might prefer to analyze this case as a primary purpose/commercial activity problem,¹⁵⁹ I also believe the facts of this example would fit the second paradigm of the failure-to-serve rationale, where an exempt charity has entered into a contract giving individuals or a for-profit entity a competitive advantage for which the charity may have undercharged (the competitive advantage here is a place to display and a mechanism to sell art that is limited to the works of the local artists, in place of them displaying/selling their art through normal commercial channels). Under my proposed analysis, therefore, the charity would be required to present a reasonable justification for why this arrangement appropriately conserves charitable assets for use across the charitable class. Although the example obviously does not address this final step, I could imagine that it would be difficult to come up with such a justification—for example, it seems that a reasonable justification under these circumstances would require the organization to compare its financial arrangements with those of other art galleries; the 10% commission may well be “below market” and hence the gallery in this case would not properly be preserving assets for the charitable class (which in this case is presumably the general community that gets to view and buy the art in question).¹⁶⁰

156. *Id.*

157. *Id.*

158. The example states, “Because [the organization] gives 90 percent of the proceeds from its sole activity to the individual artists” the organization fails the private benefit analysis—indicating that the private benefit failure is not because of the limited charitable class, but rather because of the economic benefits flowing to the artists. *Id.*

159. It appears that the organization in this example is indistinguishable in its activities from any commercial art gallery. As I note in my discussion of joint ventures, if an organization’s primary activity is simply to run a commercial business, then the organization is not exempt for lack of a primary charitable purpose. *See, e.g.*, Treas. Reg. § 1.501(c)(3)-1(e) (2006).

160. That the commission is below market is suggested by Rev. Rul. 76-152, 1976-1 C.B. 151, 1976 IRB LEXIS 621, at *1-2, which has almost identical facts to this newly-proposed example. In that ruling, the IRS noted that the commission charged was “substantially less than customary commercial charges.” *Id.*, 1976 IRB LEXIS 621, at *2. If true, this would mean that the gallery in

Finally, example three deals with an educational organization (O) whose sole activity is to train individuals in a “program” owned by for-profit company K.¹⁶¹ O licenses the program from K, and contracts with K to provide the training faculty and course materials.¹⁶² Any new course materials developed by O must be assigned to K at no charge if the nonprofit ever terminates its license with K.¹⁶³ K also sets the tuition charged by O.¹⁶⁴ Not surprisingly, the IRS concludes that this arrangement violates the private benefit doctrine.¹⁶⁵ The failure-to-serve analysis likely would reach a similar result. This example seems to be a combination of my two failure-to-serve paradigms, involving both a contract with a for-profit conferring a competitive advantage on that for-profit (the licensing arrangement giving K free access to improvements made by O upon termination of the license) and the “outsourcing” paradigm (because O contracts with K for faculty and materials). As with example two, I would expect that it would be difficult for O to come up with a reasonable justification for this arrangement based upon comparable operations of other educational organizations, which likely neither “outsource” all their teaching, nor give away valuable course improvements.

In sum, therefore, the latter two examples in the proposed regulations appear compatible with the failure-to-serve analysis. This in turn illustrates that my proposal will not radically alter the results reached in most private benefit cases, but will provide a specific, articulated rationale that charities can actually understand and apply to specific circumstances.

IV. SUMMARY

Despite my past skepticism regarding the IRS’s expanded definition of private benefit, this article illustrates that there can be a well-defined, “expanded” version of private benefit that is useful in filling analytical gaps between the primary purpose requirement and private inurement/§ 4958 analysis. So I “take back” at least some (but not all) of the horrible things I have said about the private benefit doctrine in the past. The version of private benefit sketched here, with a rationale linked to failure to conserve charitable assets and a doctrinal implementation focused primarily on two paradigms dealing with core services (the

question was failing to get adequate compensation for its services from the artists, and thus is failing to conserve assets for the charitable class.

161. Standards for Recognition of Tax-Exempt Status if Private Benefit Exists, 70 Fed. Reg. at 53,601-02.

162. *Id.*

163. *Id.* at 53,602.

164. *Id.*

165. *Id.*

outsourcing paradigm and the competitive advantage paradigm), likely would reach similar end results as many of the IRS rulings and cases (though not all, as my analysis of *American Campaign Academy* indicates), but would do so by providing a rigorous rationale and analytical framework that the doctrine currently lacks. There is no reason to let the IRS substitute an overbroad private benefit doctrine for hard analysis of the true evils of transactions between exempt organizations and for-profit ones, just as there is no reason to make charities or their tax advisors operate in analytical darkness when daylight works just as well.