Hard Don't, Soft Don't: Activity-Based Issues and Pressure Points

An Analytical Framework for Public Charities

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The Framework

Compliance/risk lenses:

- Federal Tax Law
- State Law
- Public Relations
- Governance

Variables:

- Exchange/transfer vs. conduct of activity
- Valuation challenges
- Insider compensation
- Structure of transaction

- This framework can be applied whenever evaluating transactions.
- Within this framework are hard no's and soft no's.

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Federal Tax Law: Private Inurement and Benefit

- Sibling Doctrines
  - Inurement: net earnings flowing to or for the benefit of insiders.
    - *E.g.*, excessive compensation
  - Private benefit: applies to non-insiders where operating to benefit private interests more than incidentally; flow of funds not necessary to find prohibited benefit.
    - *E.g.*, operating as a marketing/referral conduit for a commercial entity
- Inurement is the first concern with transactions with related parties, but private benefit can also crop up.
- Not always clear what is too much private benefit or incidental benefit. Often soft no issues and no bright lines.

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Federal Tax Law: Private Inurement and Benefit

- Prohibition on inurement is absolute; private benefit permitted if under the facts and circumstances and public benefit outweighs private benefit
- Penalty is loss of exemption (but see Section 4958)
- Don't forget to see the forest: doctrines apply to both individual transactions and broader operations
  - On a transactional basis: Is the transaction reasonable or at fair market value and in the interests of the exempt organization and its purposes?
  - On a governance/operations level: is there a significant or structural conflict of interest that could cause the charity to act for private interests?

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Federal Tax Law: Intermediate Sanctions (Section 4958)

- Alternative to revocation for violations of private inurement
- Penalizes transactions in which a "disqualified person" receives an economic benefit that exceeds the value that the exempt organization receives in return ("excess benefit transactions")
- Applicable generally to Section 501(c)(3) (excluding private foundations and certain governmental entities) and Section 501(c)(4) organizations
- Penalties are imposed on the disqualified persons and potentially on organizational managers who approve a transaction knowing it conveys excess benefit

Federal Tax Law: Intermediate Sanctions (Section 4958)

- Key Aspects:
    - Identity of Disqualified Persons
    - Standards for Fiduciaries
        - "Knowing" can mean negligently failing to perform duty
        - Reliance on reasoned opinion of outside expert
    - Rebuttable Presumption of Reasonableness
        - Independent authorized body
        - Comparability data
        - Timing
        - Documentation
        - Whether a transaction is reasonable involves soft no considerations

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