PRESENTED AT

Higher Education Taxation Institute

June 5, 2023
Austin, TX

Excerpt, "Tax-Exempts as Partners in Your Transactions"

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TAX-EXEMPTS AS PARTNERS IN YOUR TRANSACTIONS (2017)

By

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I. BASIC TAX EXEMPTION RULES IN THE TRANSACTIONAL CONTEXT

A. Key Tax Exemption Criteria

Whenever an IRC § 501(c)(3) organization enters into a transaction, it needs to consider whether doing so could place its tax-exempt status at risk. To maintain its tax-exempt status, the organization must meet the statutory requirements of § 501(c)(3): it must be organized and operated exclusively for tax-exempt purposes, no part of its earnings may inure to the benefit of private shareholders or individuals, no substantial part of its activities may consist of lobbying, and it may not intervene in a political campaign by endorsing or opposing a candidate for public office. In the transactional context, the most commonly encountered tax exemption issues are whether the transaction permits the organization to continue to be operated exclusively for tax-exempt purposes, and whether impermissible private inurement or private benefit results from the transaction.

1. Operating exclusively for tax-exempt purposes.

a. IRC § 501(c)(3) requires organizations to be organized and operated "exclusively" for charitable, educational, and other specified purposes. Failure to satisfy either the "organizational" or "operational" test results in denial or loss of exemption.

b. An organization will satisfy the operational test only if it engages primarily in activities that accomplish one or more of the exempt purposes specified in § 501(c)(3). Treas. Reg. § 1.501(c)(3)-1(c)(1). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

c. The existence of a single substantial nonexempt purpose, regardless of the number or importance of exempt purposes, will cause failure of the operational test. <u>Better Business Bureau of Washington, D.C. v. U.S.</u>, 326 U.S. 279 (1945).

d. Prior to entering into a transaction, a tax-exempt organization should assess whether engaging in the transaction furthers its tax-exempt purposes. If it is determined that the transaction does not further a tax-exempt purpose, the organization should determine that the activity to be carried out by the transaction is insubstantial in relation to the overall activities of the organization. Substantiality is determined based on facts and circumstances.

2. Private benefit.

a. The private benefit doctrine is grounded in the requirement that, as a condition of its exemption under section 501(c)(3) of the Code, an organization must establish that it serves a public rather than a private interest and 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." Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

b. While the Treasury regulations list only persons with close ties to the organization as those prohibited from benefiting from the organization's activities, the private benefit doctrine has been applied not only with respect to such "insiders," but with respect to unrelated third parties as well. <u>Christian Stewardship Assistance, Inc. v. Commissioner</u>, 70 T.C. 1037 (1978); <u>American Campaign Academy v. Commissioner</u>, 92 T.C. 1053 (1989).

c. Private benefit need not involve the receipt by private persons of the earnings of a section 501(c)(3) organization, but may take the form of any "advantage, profit, fruit, privilege, gain [or] interest." <u>American Campaign Academy v. Commissioner</u>, 92 T.C. 1053 (1989) (quoting <u>Retired Teachers Legal Defense Fund v. Commissioner</u>, 78 T.C. 280 (1982)).

d. In order not to jeopardize an organization's exempt status, a private benefit conveyed by the organization must be both qualitatively and quantitatively incidental to the public benefit conveyed. *See* GCM 37789 (12/18/78).

(1) A private benefit is considered qualitatively incidental only if it is a necessary by-product of the public benefit provided, in that the public benefit cannot be achieved without a benefit to private interests.

(a) In Rev. Rul. 70-186, 1970-1 C.B. 128, an organization was created to maintain and improve a lake open to the general public for recreational purposes. The treatment of the lake water, removal of algae and other improvements to the lake necessarily increased the value of lakefront properties, thereby privately benefiting the properties' owners. Concluding that it was impossible for the organization to carry out its exempt purpose of maintaining the lake as a public recreational facility without necessarily benefiting the lakefront property owners, the IRS concluded that the private benefit flowing from the organization's activities was incidental to the public benefit it served and thus did not jeopardize the organization's exempt status.

(b) In Rev. Rul. 75-286, 1975-2 C.B. 210, the IRS concluded that an organization organized to maintain and improve a city block was not operated exclusively for exempt purposes. Unlike the organization in Rev. Rul. 70-186, the organization in Rev. Rul. 75-286 granted membership access only to residents of the relevant city block and limited its expenditures to a confined area abutting the members' properties. The IRS held that the organization was created and operated to benefit the private interests of members by increasing the value of their properties, a benefit that was not merely incidental to a larger public benefit given the narrow scope of the organization's improvement projects.

(2) The determination of whether a private benefit is quantitatively incidental to a public benefit is made by comparing the magnitude of the private benefit to the magnitude of the public benefit based on all available facts and circumstances. *See* GCM 35701 (3/4/74); GCM 39862 (12/2/91).

(a) The larger the public benefit, the larger the permissible private benefit.

(b) Only the public benefit served by the activity bestowing the private benefit, not the public benefit of all of an organization's activities, is considered. *See* GCM 37789 (12/18/78); TAM 9451001 (12/23/94).

e. For purposes of establishing that the tax-exempt participant has not conferred inappropriate private benefit on the for-profit participant in a transaction, the arrangement must be negotiated at arm's length and for fair market value.

(1) In particular, a tax-exempt co-venturer will seek to ensure that its equity interest in the venture represents fair market value for the funds, services, intellectual property, etc. it contributes to the joint venture. It is not uncommon for tax-exempt co-venturers to insist on third-party valuations to establish fair market value. Where payments are found to be at fair market value, a finding of private benefit is significantly less likely. *See* Bob Jones University Museum and Gallery, Inc. v. Commissioner, T.C. Memo 1996-247 (1996) ("The principal inquiry in determining whether rental arrangements create private benefit or inurement is whether the rental payments are excessive.") *See also* FSA 199911009 (12/8/98) ("[T]he threshold question is whether the benefit a section 501(c)(3) organization provides to an unrelated third party is a fair market value exchange for the consideration provided by the third party. Only if the party is provided with greater than fair market value (or the organization receives less than fair market value consideration for the benefit provided) is private benefit to the third party present.")

(2) Challenges may arise when it is difficult (or seemingly impossible) to establish fair market value independently. This can occur when the venture is so novel or unique that a third-party appraisal is unavailable. In those circumstances, the parties will generally rely on the existence of an arm's length negotiation to establish fair market value. *See* Rev. Rul. 76-91, 1976-1 C.B. 149 ("Generally, where an organization purchases assets from an independent third party, a presumption exists that the purchase price (arrived at through negotiations) represents fair market value. However, where the purchase is controlled by the seller (or there is a close relationship between the two) at the time of the sale, this presumption cannot be made because the elements of an arm's length transaction are not present.")

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