

Introduction*

This paper contains reflections on three distinct but closely-related notions in the Internal Revenue Code. All concern charities described in § 501(c)(3)¹ but two also impact other types of tax-exempt organizations.² Two are creatures of the statute;³ the other is a child of the Treasury Regulations.⁴ Two are of fairly ancient lineage⁵ whereas the third is not yet ten years old.⁶ Taken together, they police the quintessential characteristic of charities: that they operate for the public benefit and do not permit their assets or activities to profit persons other than their intended beneficiaries.⁷

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¹ All section references, unless otherwise indicated, are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

² As will be seen, the inurement proscription applies to many types of organizations described in § 501(c). The § 4958 excess benefit regime covers both § 501(c)(3) charities (except private foundations) and § 501(c)(4) social welfare organizations. § 4958(e). The principal focus in this paper will be upon charitable, i.e., § 501(c)(3), organizations.

³ The inurement regime is based upon language in § 501(c)(3) and several other paragraphs of § 501(c), although substantially-identical words also appear in Treas. Reg. § 1.501(c)(5)-1(a)(1). The excess benefit rules are contained in § 4958.

⁴ The limitation on private benefit stems from Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii), which reads:

“An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, 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.”

⁵ The statutory anti-inurement language in § 501(c)(3) dates from 1909. See text accompanying note 13 below. The regulatory private-benefit-limiting language was first adopted in 1959 by T.D. 6391, 24 Fed. Reg. 5217, 5219 (1959).

⁶ § 4958 was added to the Code by § 1311(a) of the Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996), which was signed into law by President Clinton on July 30, 1996. It was made effective retroactively to Sept. 14, 1995. See note 136 below.

⁷ This paper focuses on federal tax rules. The I.R.S., however, is only one — and certainly not the most important one — of the agencies which police the nonprofit sector. State Attorneys General and other State charity officials have much broader powers and standing to patrol not-for-profit organizations. See generally MARION FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS* ch. 6 (2004). Under certain circumstances, others may also have standing, for example trustees, directors, donors, members, and actual or potential beneficiaries. See generally MARY GRACE BLASKO, CURT S. CROSSLEY & DAVID LLOYD, *STANDING TO SUE IN THE CHARITABLE SECTOR* (4 Topics in Philanthropy, N.Y.U. Program on Philanthropy and the Law,

The three doctrines are: (1) the proscription against inurement, (2) the proscription against more-than-incidental private benefit, and (3) the rules imposing excise taxes on excess benefit transactions. They will be discussed in that order. The paper does not aspire to provide a comprehensive description or analysis of any of them. Rather, it contains selected observations stemming from the author's teaching and writing in this area for more than 15 years. A secondary purpose of the paper is to recount some ancient history⁸ and capture some current events.⁹ As an aid to the pilgrim, several appendices appear at the end of this paper to provide ready reference to rulings, G.C.M.'s, cases, and secondary-source materials bearing on these matters.¹⁰

Inurement

Peril awaits anyone who attempts to understand the tax law without rigorously parsing the language of the Internal Revenue Code. Many results, happy or foolish, turn on a microscopic scrutiny of the words of that statute. It is tempting to carry that habit pattern forward into an understanding of the inurement proscription contained in § 501(c)(3). In this case, however, the temptation should be avoided. This paper will demonstrate, in three steps, why the relevant statutory language is close to meaningless, making it necessary to resort to other sources to understand the scope of the inurement rules.

Step 1: The Legislative History. The template for all of the inurement provisions was designed in 1909. Section 38 of the legislation¹¹ imposed a "special excise tax" on corporations.¹² Several types of organization were excepted, including "any corporation

1993), also published in slightly different form as Mary Grace Blasko, Curt S. Crossley & David Lloyd, Standing to Sue in the Charitable Sector, 28 U.S.F.L. REV. 37 (1993).

⁸ The history of the enactment of the first (1909) legislation containing anti-inurement language is discussed in the text accompanying notes 11 through 27 below.

⁹ The history of the enactment of the recent intermediate sanctions legislation — § 4958 — is discussed in the text accompanying notes 86 through 102 below.

¹⁰ Appendix A lists the principal published G.C.M.'s and Revenue Rulings. Appendix B contains citations to the leading cases. Appendix C is a selected bibliography of secondary source materials.

¹¹ The Act is entitled, "An Act to Provide Revenue, Equalize Duties and Encourage the Industries of the United States, and for Other Purposes." Pub. L. No. 61-5, 36 Stat. 11 (1909). It was signed on Aug. 5, 1909.

¹² The tax was structured as an excise, rather than as an income, tax because of Congressional concerns that an income tax might be unconstitutional under Pollock v. Farmers' Loan & Trust Co., 157 U.S. 601 (1895). As Senator Flint put it, "The [Senate Finance] committee decided that, . . . in view of the decision of the Supreme Court in the Pollock case, it would be indelicate, at least, for the Congress of the United States to pass

or association organized and operated exclusively for religious, charitable, or educational purposes, *no part of the net income of which inures to the benefit of any private stockholder or individual.*"¹³ The legislative history of this language should, one might hope, provide a rich source of enlightenment. One hopes in vain. A few weak beams of light emerge, but most of the important issues remain shadowed.¹⁴

On the floor of the Senate, on July 2, 1909, Senator Augustus O. Bacon, from Georgia, offered an amendment to then-pending bill. Among the amendment's provisions was the following:

*"Provided, That the provisions of this section shall not apply to any corporation or association organized and operated for religious, charitable, or educational purposes, no part of the profit of which inures to the benefit of any private stockholder or individual, but all of the profit of which is in good faith devoted to the said religious, charitable, or educational purpose."*¹⁵

Although the amendment was then laid on the table, i.e., was defeated,¹⁶ it re-emerged several days later.

Senator Bacon moved his amendment again, in exactly the same language, on July 6, 1909.¹⁷ This time it was successful,¹⁸ but not before some interesting debate. Senator Clark of Wyoming first challenged Senator Bacon, asking whether the amendment would exempt the Trinity Church Corporation of New York City. Senator Clark said that Trinity Church took in hundreds of thousands of dollars each year as rents, and thought it should be subject to taxation despite its lack of stockholders.¹⁹ After some discussion by various Senators (not including Senator Bacon) about the nature and size of the activities of Trinity Church, Senator Bacon replied:

another [income tax] measure and ask the Supreme Court to pass upon it, when they had already passed upon the proposition in that case." 44 Cong. Rec. 3936 (1909) (Proceedings on June 29, 1909).

¹³ Pub. L. No. 61-5, § 38, 36 Stat. 11, 115 (1909) (emphasis added).

¹⁴ Because no printed committee reports address the issue, all of the meager illumination comes from Congressional debates.

¹⁵ 44 Cong. Rec. 4061 (1909) (italics in original). Note that the phrase "organized and operated" is not at this point followed by the word "exclusively." See text accompanying note 23 below.

¹⁶ 44 Cong. Rec. 4061-62 (1909).

¹⁷ See generally 44 Cong. Rec. 4149-57 (1909).

¹⁸ 44 Cong. Rec. 4157 (1909).

“[I]f it be true that there are features in the business of that [Trinity Church] corporation which are not strictly religious, educational, or benevolent, they would not be screened by this amendment; and if they are all of them religious, benevolent, and educational, the fact of their magnitude would not, in my opinion, be any reason why we should exclude them from the beneficial provisions of this amendment.

“. . . [T]he corporation which I had particularly in mind as an illustration at the time I drew this amendment is the Methodist Book Concern, which has its headquarters in Nashville, which is a very large printing establishment, and in which there must necessarily be profit made, and there is a profit made exclusively for religious, benevolent, charitable, and educational purposes, in which no man receives a scintilla of individual profit.”²⁰

Senator Flint from California then joined the fray, asking Senator Bacon whether the exemption amendment was necessary, given that the taxing language only applied in the first instance to organizations which were “for profit.”²¹ Senator Bacon replied that the amendment was indeed required:

“I gave the illustration of the Methodist Book Concern for that reason. It is organized for profit, but it is not organized for individual profit. It is organized to make a profit to extend religious work and to extend benevolent work, charitable work, and educational work. It is organized for profit, and does make a profit. That is the very reason why I think the words of the amendment with reference to a corporation tax are not sufficient.”²²

Senator Bacon then proceeded to make a change in his own suggested exemption language by inserting “exclusively” after “organized and operated.” That change, he opined, “would make it as complete as it is possible to do.”²³

After some far-ranging debate about other aspects of the amendatory language, concerning building and loan associations, labor unions, and the like, the amendment was

¹⁹ 44 Cong. Rec. 4149 (1909).

²⁰ 44 Cong. Rec. 4151 (1909).

²¹ Ibid.

²² Ibid.

finally approved. Thus, as the Bill emerged from the Senate, the exemption language read as follows:

*“Provided, however, that nothing in this section contained shall apply to . . . any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the profit of which inures to the benefit of any private stockholder or individual, but all of the profit of which is in good faith devoted to the said religious, charitable, or educational purposes.”*²⁴

The quoted anti-inurement language was later changed in two ways prior to enactment: the word “profit” was changed to “net income” and the final clause (beginning “but all of the profit of which”) was deleted.²⁵ The conference committee that adopted those two final changes did not provide, nor can one find from any other source, any explanation of its reasoning,²⁶ so one is left to wonder whether any change in substance was intended.²⁷

While the debates provide some useful background to the development of the statutory language, they do not sufficiently explain why the words “profit,” “net income,” “private stockholder,” or “individual” were selected or rejected. The present version of the anti-inurement language contains two further changes: “net income” has become “net earnings” and “stockholder” has become “shareholder.”²⁸ Once again, it is impossible to discern any rationale for the verbal variations. As will be shown below, the words — if taken literally — would pose a number of important puzzles and problems. Given all of

²³ *Ibid.*

²⁴ 44 Cong. Rec. 4157 (1909) (emphasis in original).

²⁵ The final statutory language is quoted in the text accompanying note 13 above.

²⁶ See 44 Cong. Rec. 4630, 4649 (1909), reporting the proceedings on July 30, 1909. The language of the anti-inurement provision, as the bill emerged from Congress on that date, remained unchanged; it was exactly as it appeared in the final statute. A careful search of the Congressional Record shows there was no discussion of the wording of the provision after the July 6 session. There is, therefore, no clarification of the changes that took place between July 6 and the adoption on July 30 of the conference committee version. There are no records of the deliberations of the conference committee. The legislative history on these points is therefore completely arid.

²⁷ One article speculates that the deletion of the final clause occurred “in all likelihood because it was redundant.” Note, “The Inurement of Earnings to Private Benefit” Clause of Section 501(c): A Standard Without Meaning?, 48 MINN. L. REV. 1149, 1151 n. 10 (1964). Perhaps so, but no citation is provided for that speculation.

²⁸ § 501(c)(3). It seems clear that the latter change signifies nothing. Compare § 2055(a)(2)’s anti-inurement language — using “stockholder” — with § 2055(a)(4)’s anti-inurement language — using “shareholder.” It would be beyond anyone’s imagination to suppose that some difference was intended between these two paragraphs of the same Code section.

this opaque history, however, it seems wiser to treat the anti-inurement language as evocative rather than precise.

Step 2: A Comparison of the Words. Anti-inurement language appears in nine separate paragraphs of § 501(c)²⁹ and in at least 13 other places in the Code.³⁰ Although the theme is fairly clear, the notes vary.

The language is identical in four paragraphs of § 501(c).³¹ It varies trivially, and in ways which seem immaterial, in two others.³² In two further cases, the inurement language is modified to permit certain types of intended benefits to flow to intended beneficiaries.³³ In one case, however, the language is inexplicably different: the anti-inurement prohibition for social clubs applies to “any private shareholder,” but does not extend, as in all of the other cases, to any “individual.”³⁴ Lacking any precedent or text explaining this distinction,³⁵ one could reason in one of two ways:

1. Language in the Code is important, so social clubs may retain tax-exempt status even if they *permit* inurement to the benefit of an individual, or
2. Language in this instance is not very important, so one should not expect the scope of the anti-inurement prohibition to differ when applied to social clubs.

The latter seems correct.³⁶

²⁹ §§ 501(c)(3), (4)(B), (6), (7), (9), (11)(A), (13), (19)(C), and (26)(D).

³⁰ §§ 170(c)(2)(C), 170(c)(3)(B), 170(c)(5), 526, 528(c)(1)(D), 833(c)(3)(A)(vi), 2055(a)(2), 2055(a)(4), 2106(a)(2)(A)(ii), 2522(a)(2), 2522(b)(2), 2522(b)(5), and 4421(2)(B).

³¹ §§ 501(c)(3), (6), (13), and (19)(C).

³² § 501(c)(4)(B) uses “of such entity” rather than “of which.” § 501(c)(26)(D) uses “of the organization” rather than “of which.”

³³ § 501(c)(9), describing voluntary employees’ beneficiary associations which provide payments for “life, sick, accident, or other benefits” to their members, contains a parenthetical exception from the anti-inurement language reading “other than through such payments.” Similarly, § 501(c)(11)(A), describing teachers’ retirement fund associations, contains a parenthetical exception from that language reading “other than through payment of retirement benefits.”

³⁴ § 501(c)(7). The regulations track that language. Treas. Reg. § 1.501(c)(7)-1(a). In an earlier incarnation, the exemption for social clubs contained anti-inurement language which applied not only to “private shareholders” but also to “any member.” The “member” language was deleted in 1924. Revenue Act of 1924, § 231(9), 43 Stat. 253, 282. “Nevertheless, cases and rulings continue to refer to benefits that inure to *members*.” 1 ROBERT J. DESIDERIO & SCOTT A. TAYLOR, PLANNING TAX-EXEMPT ORGANIZATIONS 28-9 (1990) (emphasis in original).

³⁵ The author would be grateful for illumination should anyone know of guidance on this point.

³⁶ Two leading treatises, for example, discuss the private inurement doctrine as applied to social clubs without ever mentioning the linguistic difference. FRANCIS R. HILL & DOUGLAS M. MANCINO, TAXATION OF EXEMPT ORGANIZATIONS ¶ 16.02[6] (2002); BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS § 19.7 (8th ed. 2003).

Although most of the anti-inurement rules are codified in the statute, one — dealing with labor, agricultural, and horticultural organizations³⁷ — is found only in the regulations.³⁸ The current regulation was proposed in 1956³⁹ and adopted in 1958.⁴⁰ Its language is closely similar to the statutory proscriptions: it provides that qualifying entities must “[h]ave no net earnings inuring to the benefit of any member.”⁴¹ Similar language has appeared in the regulations under § 501(c)(5)’s predecessors since at least 1924, but the language prior to 1958 referred to “net income” rather than “net earnings.”⁴² Consistent with the arguments made above, that verbal distinction is probably without legal significance.

Step 3: Deconstruction of the Words. The statutory language prohibits the inurement of “net earnings”⁴³ to the benefit of “any private shareholder or individual.”⁴⁴ A moment’s thought exposes so many problems with those words that it seems clear they cannot be read literally. For example, as one trenchant commentator recently put it, “Lit-

³⁷ These are the organizations described in § 501(c)(5).

³⁸ See also Temp. Treas. Reg. § 1.892-2T(b). § 892 exempts from taxation certain income of foreign governments and their controlled entities. The regulations require that none of the “net earnings” or “income” of the qualifying government or its controlled entities may inure to the benefit of “any private person.” Temp. Treas. Reg. §§ 1.892-2T(a)(2) and -2T(a)(3)(iii). Temp. Treas. Reg. § 1.892-2T(b) then describes the circumstances under which such inurement will be deemed to occur. Because the purpose for and policies behind § 892 are different from those affecting § 501, however, it would be unwise to reason from the regulations under the former to the latter. To glimpse the purposes behind the anti-inurement rules under § 892, see Louis Vial v. Commissioner, 15 T.C. 403 (1950), acq., 1952-1 C.B. 4; Rev. Rul. 66-73, 1966-1 C.B. 174, revoked by Rev. Rul. 75-298, 1975-2 C.B. 290, which in turn was declared obsolete, Rev. Rul. 2003-99, 2003-34 I.R.B. 388; and Rev. Rul. 88-7, 1988-1 C.B. 269, also declared obsolete, Rev. Rul. 2003-99, 2003-34 I.R.B. 388.

³⁹ 21 Fed. Reg. 460, 465 (Jan. 21, 1956).

⁴⁰ T.D. 6301, 23 Fed. Reg. 5,192, 5,195 (July 28, 1958), 1958-2 C.B. 197, 203. Although the regulation was later amended by T.D. 8726, 62 Fed. Reg. 40,447 (1997), 1997-34 I.R.B. 7, this last amendment did not modify the anti-inurement language.

⁴¹ Treas. Reg. § 1.501(c)(5)-1(a)(1). Note that the word “member” replaces the words “any private shareholder or individual.” It is fascinating to contrast this regulatory language, referring only to “member” and not to “private shareholder or individual,” with the statutory language under § 501(c)(7), referring only to “private shareholder” and not to “individual” or “member.”

⁴² See and compare, e.g., Treas. Reg. Art. 512 (1924); Treas. Reg. Art. 101(1)-1 (1936), 1 Fed. Reg. 1868 (1936); and Treas. Reg. § 39.101 (1)-1 (1949).

⁴³ Recall that at earlier times, the words “profit” and “net income” were sometimes used in lieu of “net earnings.” See text accompanying notes 13, 15, 25, and 42 above.

⁴⁴ The regulations provide that “[t]he words private shareholder or individual in section 501 refer to persons having a personal and private interest in the activities of the organization.” Treas. Reg. § 1.501(a)-1(c). To say, as one author wrote, that this statement is “not terribly helpful” is being unduly kind. Peter L. Faber, The Effect of Intermediate Sanctions on the Ultimate Sanction for Tax-Exempt Organizations, 16 EXEMPT ORG. TAX REV. 587, 590 (1997).

erally, this could apply to any individual regardless of his or her connection with the organization. The statute's reach obviously cannot be this broad."⁴⁵ All relevant precedent agrees. To hammer the nail firmly into place, nevertheless, each of the relevant words and phrases will be examined in more detail.

Should the proscription against inurement of "net earnings" be read to permit, without sanction, the inurement of *gross* earnings? Or "revenue"? Or "assets"? Certainly not. One early decision stated that the phrase may include "more than the term net profits as shown by the books of the organization or than the difference between gross receipts and disbursements in dollars."⁴⁶ In 1974, the 6th Circuit Court of Appeals quoted that case with approval and added that "[e]arnings may inure to an individual in ways other than through the distribution of dividends."⁴⁷ Other courts have agreed.⁴⁸ The Service has said that "the inurement prohibition, while stated in terms of the net earnings of an organization, applies to any of [an organization's] charitable assets. It applies to more than just the net profits shown on the books of the organization or the surplus of gross receipts over disbursements in dollars."⁴⁹ It must be concluded that the words "net earnings" neither well aim at nor well circumscribe the target.

We next turn to the phrase "private shareholder." It is puzzling at the outset to ponder the meaning of the adjective: is there some difference intended, perhaps, between a "private" shareholder and some other type of shareholder, e.g., a "public" shareholder?⁵⁰ The more serious puzzle is: under what circumstances need we be concerned about inurement to *any* sort of "shareholder"? The I.R.S. will not generally permit a corporation to qualify as a charitable organization unless it is formed as a not-for-profit entity, i.e., unless it totally lacks shareholders.⁵¹ Thus, virtually no corporate charities have any shareholders

⁴⁵ *Ibid.*

⁴⁶ *Northwestern Municipal Ass'n v. United States*, 99 F.2d 460, 463 (8th Cir. 1938).

⁴⁷ *Harding Hosp., Inc. v. United States*, 505 F.2d 1068, 1072 (6th Cir. 1974).

⁴⁸ E.g., *Lowry Hosp. Ass'n v. Commissioner*, 66 T.C. 850, 858 (1976).

⁴⁹ G.C.M. 39,862 (Nov. 21, 1991) (citation omitted).

⁵⁰ For an early, but not very illuminating, discussion of this question, see T.B.R. 33, 1 C.B. 199 (1919).

⁵¹ For example, Rev. Rul. 56-185, 1956-1 C.B. 202, states:

"If provision is made in the bylaws for dividends, exemption will not be allowed even though no dividends have been declared. Exemption will not be defeated, however, merely because the shareholders or members might possibly at some future date share in the assets upon dissolution in the

(although they may indeed have members). The only known exceptions involve situations in which the entity, while formed under for-profit statutes for some special reason, has taken steps to denude the shares of any rights to dividends or other distributions both during its continued existence and upon liquidation.⁵² The number of such exceptions is so miniscule that one cannot believe it should have been important to single out “shareholders” as a meaningful class of potential recipients of inurement.

The statute also says that no benefits may inure to any private “individual.”⁵³ It has

absence of a case of mala fides where there appears to be a plan on the part of the shareholder or individual to acquire assets on the dissolution of the corporation.”

The second quoted sentence is clearly wrong. Treas. Reg. § 1.501(c)(3)-1(b)(4) provides that “an organization does not meet the organizational test if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.” In Rev. Rul. 69-545, 1969-2 C.B. 117, the Service modified Rev. Rul. 56-185, stating:

“ . . . Revenue Ruling 56-185 is ambiguous in that it can be read as implying that the possibility of ‘shareholders’ or ‘members’ sharing in the assets of a hospital upon its dissolution will not preclude exemption of the hospital as a charity described in section 501(c)(3) of the Code. Section 1.501(c)(3)-1(b)(4) of the regulations promulgated subsequent to Revenue Ruling 56-185 makes it clear, however, that an absolute dedication of assets to charity is a precondition to exemption under section 501(c)(3) of the Code.”

This is consistent with one of the earliest pronouncements on the anti-inurement proscription. In it, the Service speculated that the accumulation of earnings, even if not distributed as dividends, would constitute inurement through enhancement to the value of the corporate stock. It held that it did not have to decide that question, however, because the payment of dividends on the stock was sufficient to disqualify the entity from tax-exempt status. T.B.R. 33, 1 C.B. 199 (1919).

⁵² The IRS has ruled that ownership of stock is not fatal to tax-exempt status if the stock has neither the right to dividends nor to receive assets upon dissolution. Rev. Rul. 68-222, 1968-1 C.B. 243, restating I.T. 3860, 1947-2 C.B. 70. (Both precedents involved title-holding companies for a § 501(c)(7) fraternity.) The IRS has issued several private letter rulings confirming the tax-exempt status of for-profit healthcare organizations when, under the relevant state law, nonprofit entities were not allowed to practice medicine. Three such entities held exempt, under § 501(c)(3), were North Shore Medical Specialists (Chicago) (P.L.R., unnumbered, dated Nov. 22, 1996, 96 TAX NOTES (TA) TODAY 234-30 (Dec. 3, 1996)); Physicians Network P.C. (Poughkeepsie, N.Y.) (P.L.R., unnumbered, dated Oct. 23, 1996, 96 TAX NOTES (TA) TODAY 216-21 (Nov. 5, 1996)); and Marietta Health Care Physicians Inc. (Marietta, Ohio) (P.L.R., unnumbered, dated Oct. 3, 1995, 95 TAX NOTES (TA) TODAY 202-39 (Oct. 17, 1995)). In each case, of course, the corporate documents and shareholder agreements eliminated from the stock all rights to distributions. See Marlis L. Carson, IRS Approves Exemption for Chicago For-Profit Medical Corporation, 73 TAX NOTES (TA) 1153 (1996). See also the private letter ruling granting exempt status under § 501(c)(3) to United Medical Associates, P.C., 98 TNT 22-41 (Jan. 28, 1998) (same). A confirmed cynic might note that use of the for-profit form contains some dangers even if the corporate documents do remove beneficial interests from the shares: a later amendment, just prior to dissolution, might restore those beneficial interests. Although this risk has been noticed, Note, “The Inurement of Earnings to Private Benefit” Clause of Section 501(c): A Standard Without Meaning?, 48 MINN. L. REV. 1149, 1156 (1964), it has apparently not concerned the Service.

⁵³ The I.R.S. quite early held that “[t]he word ‘private’ modifies both the word ‘stockholder’ and the word ‘individual.’” T.B.R. 33, 1 C.B. 199, 200 (1919). (In 1919, the anti-inurement language referred to “stockholder” rather than, as now, “shareholder.”) That ruling went on to conjecture that presumably the use of the word “individual” “was necessary to bring within it members of corporations who were not technically stockholders.” Clearly the anti-inurement language has been interpreted, properly, much more broadly than

already been noted that it would produce absurd results to read the word broadly because individuals are almost always the intended and perfectly -acceptable beneficiaries of charity.⁵⁴ As the Tax Court has said, “to equate an ‘insider’ with potentially the whole community would so gut the insider test as to transmogrify it from a test of some precision . . . to a test of such general application as to be useless.”⁵⁵

Is the language also too narrow? For example, reasoning by negative implication, should the statute be read as permitting benefits to inure to partnerships or corporations? The relevant regulations define “private shareholder or individual” to include “persons,”⁵⁶ which should be taken to invoke the Code definition: “The term ‘person’ shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.”⁵⁷ The Service has opined that “a labor union . . . is a ‘person’ to whom the inurement proscription applies.”⁵⁸ In G.C.M. 39,414,⁵⁹ the Service stated:

“In our opinion, a section 501(c)(3) organization may not loan its funds to private individuals *or corporations* for use in a business context without violating the statutory prohibition against private inurement.” (Emphasis added.)

A leading commentator has written that “[t]he private inurement doctrine can be triggered by the involvement of persons other than individuals, such as corporations, partnerships, limited liability companies, estates, and trusts.”⁶⁰

Even the word “inurement” is problematical. It is, of course, perfectly clear that it cannot be read to prohibit the conferring of *any* benefit on an insider: G.C.M. 39,862 concedes (and all authorities agree) that “[t]he inurement proscription does not prevent the payment of reasonable compensation for goods or services.” In its search for a touchstone, the G.C.M. suggests that the word “is aimed at preventing *dividend-like* distribu-

that conjecture contemplated. G.C.M. 38,322 (Mar. 24, 1980) says: “The word ‘private’ is the antonym of ‘public’ — used to distinguish a private individual from the general public — and is intended to limit the scope of those persons who personally profit from the organization to the intended beneficiaries of the allowable activities.”

⁵⁴ See text accompanying note 45 above.

⁵⁵ Sound Health Ass’n v. Commissioner, 71 T.C. 158, 186-87 (1978).

⁵⁶ Treas. Reg. § 1.501(a)-1(c).

⁵⁷ § 7701(a)(1).

⁵⁸ G.C.M. 38,322 (March 24, 1980).

⁵⁹ Sept. 25, 1985.

tions of charitable assets or expenditures to benefit a private interest.”⁶¹ Even that suggestion, however, cannot be accepted. For example, if the organization lacked earnings and profits, it nevertheless would be susceptible to violating the anti-inurement rules.⁶² As noted previously, one court has properly observed that “[e]arnings may inure to an individual in ways other than through the distribution of dividends.”⁶³ As the Tax Court confirmed, however, inurement cannot occur without the intentional participation of the charity — theft by insiders at least sometimes does not constitute inurement.⁶⁴

There is so little content, then, in the words of the anti-inurement language that the scope of the prohibition must be sought elsewhere. The anti-inurement phrases should be recognized as Code-speak rather than English. Brain cells should be cauterized against any temptation to resort to the words for meaning. Reference, instead, should be to the various cases and other precedents which have interpreted the proscription. Although it is outside the scope of this paper to analyze the precedents,⁶⁵ several observations are in order:

1. The determination is inherently fact specific.

⁶⁰ BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 484 (8th ed. 2003).

⁶¹ G.C.M. 39,862 (Nov. 21, 1991) (emphasis added).

⁶² A “dividend” is a distribution out of accumulated or current earnings and profits. § 316(a). A corporation without earnings and profits thus cannot pay a “dividend.”

⁶³ *Harding Hosp., Inc. v. United States*, 505 F.2d 1068, 1072 (6th Cir. 1974), referred to in the text accompanying note 47 above.

⁶⁴ *Variety Club Tent No. 6 Charities, Inc. v. Commissioner*, T.C. Memo. 1997-575 (1997). The Court weakly attempted to clarify its holding as follows:

“[the] suggestion that inurement means the *intentional* conferring of a benefit cannot be allowed to mean that there is no inurement unless ‘all the organizations’ officers and board members have actual knowledge of, and affirmatively act to cause, the prohibited benefit.’ By the same token, we do not believe that the Congress intended that a charity must lose its exempt status merely because a president or a treasurer or an executive director of a charity has skimmed or embezzled or otherwise stolen from the charity, at least where the charity has a real-world existence apart from the thieving official.” 72 T.C.M. (RIA) at 3794 (emphasis in original).

It seems clear that the Court was only posing, rather than resolving, the dichotomy: sometimes the acts of insiders will *not* constitute corporate action, but sometimes their acts (even without the consent of all of the organization’s officers and board members) *will*. The opinion is devoid of any discussion of how to decide between the two. The Court also said, in passing, “[t]he boundaries of the term ‘inures’ have thus far defied precise definition.” *Ibid*.

⁶⁵ See generally Brian H. Redmond, Annotation, Federal Tax Exemption: When Do Earnings of Religious, Charitable, Educational, or Similar Organization Inure to Benefit of Private Shareholders or Individuals Within Meaning of 26 USCS § 501(c)(3), 92 A.L.R. FED. 255 (1996); BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* §§ 19.1 – 19.9 (8th ed. 2003).

2. Despite a fairly large number of precedents,⁶⁶ helpful guidance is scarce. As one court put it, more than 60 years after the anti-inurement language first appeared in the Code, “[t]here is very little material by way of guidance to this Court in the regulations or in any case law as to the application and meaning of that sentence.”⁶⁷
3. It is often fairly easy to decide what is and what is not prohibited, even though it is quite daunting to try to describe the test. As the Service’s then-Associate Chief Counsel (Employee Benefits and Exempt Organizations) put it: “In my view, the definition of inurement isn’t the problem — most practitioners and most agents know it when they see it.”⁶⁸
4. The scope of the inurement proscription has been and will be significantly affected by the adoption of § 4958.

Further comments on the fourth point will be made below.

⁶⁶ See Appendices A and B below.

⁶⁷ Universal Church of Scientific Truth v. United States, 74-1 U.S. Tax Cas. (CCH) ¶ 9,360, 32 A.F.T.R.2d 73-6122, 6123 (N.D. Ala. 1973).

⁶⁸ Speech by James McGovern to A.B.A. Tax Section, San Diego, Feb. 5, 1993, reprinted at 7 EXEMPT ORG. TAX REV. 551, 556 (1993) [hereinafter *McGovern 1993 Talk*].

Private Benefit

Precedent interprets the regulations under § 501(c)(3)⁶⁹ as creating a separate test — the more-than-incidental-private-benefit test — for tax-exempt charitable status.⁷⁰ Prior to the late 1980s, there was little guidance on the differences between the inurement and private benefit doctrines; indeed, many earlier precedents seem muddled on this point, and the lines drawn, if any, seem indistinct and confused. More recently, however, various cases and Service pronouncements have sharpened the edges of the distinctions between the two.

The first clear exposition of the tests came in G.C.M. 39,862. It set forth two sorts of distinctions:

- *First*, while the inurement proscription applies only to benefits received by “insiders,” the private-benefit proscription applies to benefits received by anyone, including wholly disinterested persons.⁷¹
- *Second*, the receipt of any benefit by an “insider,” no matter how trivial, is fatal,⁷² whereas purely “incidental” benefits received by others will *not* violate the private-benefit restriction.⁷³

⁶⁹ The relevant language is quoted in footnote 4 above.

⁷⁰ For example, the Tax Court said: “while the prohibitions against private inurement and private benefits share common and often overlapping elements, . . . the two are distinct requirements which must independently be satisfied.” American Campaign Academy v. Commissioner, 92 T.C. 1053, 1068 (1989) (citations omitted). Congress has accepted this view. E.g., H.R. Rep. No. 104-506, at 53 n. 2 (1966) (“Even where no prohibited private inurement exists, however, more than incidental private benefits conferred on individuals may result in the organization not being operated ‘exclusively’ for an exempt purpose. See, e.g., American Campaign Academy v. Commissioner”)

⁷¹ As the Tax Court agreed, “nonincidental benefits conferred on disinterested persons may serve private interests.” American Campaign Academy v. Commissioner, 92 T.C. 1053, 1069 (1989).

⁷² As G.C.M. 39,862 puts it, “inurement may be found even though the amounts involved are small. . . . There is no de minimis exception to the inurement prohibition.” Nor is it a defense that the benefit received, even if added to actual compensation paid to the benefited “insider,” would be within the bounds of reasonable compensation. The G.C.M. cites, for this proposition, Founding Church of Scientology v. United States, 412 F.2d 1197, 1202 (Ct. Cl. 1969), cert. denied, 397 U.S. 1009 (1970); Lowry Hosp. Ass’n v. Commissioner, 66 T.C. 850 (1976); and People of God Community v. Commissioner, 75 T.C. 127 (1980). Consistent with this view, the G.C.M., after finding inurement to the doctors, goes on to state “we need not consider. . . whether the benefit conferred on the physicians ever could be considered reasonable compensation” The wording of § 4958(c)(1)(A) confirms the same notion for purposes of the new intermediate-sanctions provisions: “[A]n economic benefit shall not be treated as consideration for the performance of services unless such organization clearly indicated its intent to so treat such benefit.”

The G.C.M. concludes that “[the] private benefit prohibition applies to all kinds of persons and groups, not just to those ‘insiders’ subject to the more strict inurement proscription,” and “the absence of inurement does not mean the absence of private benefit. Inurement, then, may be viewed as a subset of private benefit.”

The IRS’s later-issued Audit Guidelines for Hospitals contain the following succinct summary of these distinctions:

“Although the requirements for finding inurement or private benefit are similar, inurement and private benefit differ in two key respects. The first is that even a minimal amount of inurement results in disqualification for exempt status, whereas private benefit must be more than quantitatively or qualitatively incidental in order to jeopardize tax exempt status. The second is that inurement only applies to ‘insiders’ (individuals whose relationship with an organization offers them an opportunity to make use of the organization’s income or assets for personal gain), whereas private benefit may accrue to anyone.”⁷⁴

Thus, the inurement rules require the finding of an “insider” and are then trigger happy; the private benefit rules apply to any recipient of a private benefit but require a balancing of benefits to the public against the benefits to the recipient.

It follows from the distinctions between the inurement and excess-private-benefit proscriptions that “insider” status for purposes of the former should *not* be determined by reference to the amount of the benefit received. If receipt of a sizeable benefit transforms the recipient into an “insider,” the inurement prohibition would threaten to subsume the excess-private-benefit rule. It is clear, however, that the two are distinct, and that — if anything — the inurement regime is a subset of the private benefit prohibition.⁷⁵

There is an argument to the contrary. It should be, and has proved to be, unsuccessful. It derives from the notion that the existence of “control” can be discerned from

⁷³ G.C.M. 39,862 (Nov. 21, 1991). Accord, American Campaign Academy v. Commissioner, 92 T.C. 1053, 1068 (1989); BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS § 19.9 (8th ed. 2003) (arguing for a de minimis exception).

⁷⁴ Ann. 92-83, 1992-22 I.R.B. 59, § 333.2(2).

⁷⁵ The Tax Court has written: “[W]hile the private inurement prohibition may arguably be subsumed within the private benefit analysis of the operational test, the reverse is not true.” American Campaign Academy v. Commissioner, 92 T.C. 1053, 1068-69 (1989).

the ability to obtain a benefit from the controlled entity. For example, the § 482 regulations provide as follows:

“*Controlled* includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.”⁷⁶

The first two sentences seem apposite even to the inurement test, because they correctly would not limit the definition of “insider” to those holding titles, and they would permit the inurement prohibition to extend to any persons *actually* having the control necessary to abuse the charitable status of the organization. The last quoted sentence, however, seems inappropriate in the inurement context, because its use would tend to blur or even obliterate the separate excess-private-benefit rule.

This point was made in a 1992 New York State Bar Association Tax Section Report.⁷⁷ There is some indication that it has been accepted by the Service.⁷⁸ The Associate

⁷⁶ Treas. Reg. § 1.482-1(i)(4) (emphasis in original).

⁷⁷ Committee on Tax Exempt Entities, New York State Bar Ass’n Tax Section, Report on Exempt Organization Inurement Issues in the Context of G.C.M. 39862 (Nov. 11, 1992), reprinted at 6 EXEMPT ORG. TAX REV. 1397 (1992) [hereinafter *New York State Bar Ass’n Report on G.C.M. 39,862*]. The author was a principal drafter of the Report. The Report argued as follows:

“First, the section 482 regulation’s presumption of control arises only if the shift of income or deductions is ‘arbitrary,’ which implies ‘control.’ As a general rule, however, an amount of compensation may be determined to be unreasonable without the action that produced it being treated as arbitrary or leading to a presumption of control. Further, the role of the ‘control’ test in section 482 fundamentally differs from the role of the section 501(c)(3) inurement test. For section 482 purposes, a finding of ‘control’ permits only an adjustment, which could be quite small, of related-party pricing to an arm’s-length standard. By contrast, if ‘insider’ status is found for purposes of the inurement doctrine, any benefit, no matter how trivial, is fatal to tax exemption. Finally, unlike section 482 ‘control’ the inurement rule is not the exclusive Code method of policing receipt of benefits from a charity: even if ‘insider’ status is absent, the private-benefit doctrine will continue to apply, and tax exemption may still be lost if any such benefit is more than ‘incidental.’ For that reason, the boundaries of charitable activity can be policed even without unduly enlarging ‘insider’ status. Because the inurement doctrine is so strict and its consequences so severe, its reach should not be stretched beyond reasonable limits.

“There is an illogical circularity in testing for ‘insider’ status by looking for receipt of benefits. The inurement rules differ from the incidental-private-benefit doctrine precisely in *not* requiring a weighing of the amount of the benefit. To use the receipt of benefit, then, as a determinant of ‘in-

Chief Counsel of the I.R.S., addressing the American Bar Association Tax Section’s Exempt Organizations Committee in early 1993, referred to the New York State Bar Association’s Report as follows:

“The Report recommended that the Service clarify that ‘insider’ status is not attained automatically, solely by the receipt of a benefit from an otherwise charitable organization. I agree. The Service has never taken such a position. We never intended to suggest that receipt of a benefit should cause treatment as an insider. Insider status follows from a person’s relationship to the charitable organization.”⁷⁹

The 7th Circuit Court of Appeals, reversing the Tax Court, also has clearly rejected the notion that the receipt of even very significant benefits from a charity automatically makes the recipient an “insider.” In United Cancer Council,⁸⁰ the outside fundraiser got \$26.5 million as compensation out of a total of \$28.8 million raised for the charity.⁸¹ The appellate court declined to accept the Tax Court’s view that this caused the fundraiser to become an “insider,” holding that “the ratio of expenses to net charitable receipts is unrelated to the issue of inurement.”⁸² It concluded that the fundraiser “did not, by reason of being able to drive a hard bargain, become an insider”⁸³ Judge Posner did agree, however, that the more-than-incidental-private-benefit doctrine might apply, even though

sider’ status is to eliminate the independent status of the latter doctrine: any benefit received would serve to demonstrate ‘insider’ status, thus (a) making the finding of benefit invariably fatal to tax exemption, and (b) leaving no instance in which the incidental-private-benefit doctrine is required. That is not the law.

“We recommend, therefore, that the Service clarify that ‘insider’ status is not attained merely by the receipt of a benefit from an otherwise charitable organization.”

Id. at 1400 (Emphasis in original; citation omitted).

⁷⁸ Of course, the fact that the I.R.S. chose to assert the opposite view in the United Cancer Council litigation indicates that the Service has not *completely* accepted the point. See text accompanying notes 80 through 84 below.

⁷⁹ *McGovern 1993 Talk*, note 68 above, 7 EXEMPT ORG. TAX REV. at 555.

⁸⁰ United Cancer Council, Inc. v. Commissioner, 165 F.3d 1173 (7th Cir. 1999), rev’g and remanding 109 T.C. 326 (1997).

⁸¹ The other terms of the contract between the UCC and the fundraiser, Watson & Hughey, were also extremely favorable to the fundraiser. As the 7th Circuit Court of Appeals said, speaking with significant understatement, “[t]he terms of the contract were more favorable to the fundraiser than the terms of the average fundraising contract are.” 165 F.3d at 1176. The Tax Court, somewhat more forcefully, had held that the fundraising contract “was not a reasonable contingent compensation arrangement” and that the fundraiser’s “compensation under the Contract exceeded reasonable compensation” 109 T.C. at 397.

⁸² 165 F.3d at 1178.

the inurement proscription did not, and remanded the case to the Tax Court to decide that question.⁸⁴ The later-issued regulations, under the so-called “intermediate sanctions” provisions of § 4958, responded to the United Cancer Council decision by adding an initial-contract exception to the definition of an excess benefit transaction.⁸⁵

Excess Benefit Transactions

Following a discussion of the history of the development of the so-called intermediate sanctions rules in the Code, this part of this paper will analyze (1) the congruence between the scope of the prohibition against inurement and the scope of the new intermediate sanctions provision, and (2) certain tax consequences of “correcting” an excess benefit transaction.

History

The history of the enactment of § 4958 is interesting. Prior to 1969, the only sanction for transgression was termination of tax-exempt status. As early as 1965, the New York State Bar Association commented that an “all or nothing sanction” could lead to a “breakdown of enforcement” because the harshness of the remedy could deter the I.R.S. from invoking it and the courts from decreeing it.⁸⁶ The 1969 legislation affecting private

⁸³ 165 F.3d at 1178.

⁸⁴ In its original opinion, the Tax Court, having held for the Service on the question of inurement, did not decide the private benefit argument. See 109 T.C. at 399. Nor did it decide the issue on remand, because the parties settled the litigation before a further opinion could be issued by the Tax Court. Under the settlement agreement, the United Cancer Council agreed that it was not entitled to tax-exempt status from 1986 through 1989, and the I.R.S. agreed that it could regain its tax exemption as of 1990. The United Cancer Council also agreed that it would no longer seek to raise funds from the general public. See Closing Agreement on Final Determination Covering Specific Matters, between United Cancer Council, Inc., and the Commissioner of Internal Revenue, dated April 7, 2000, 28 EXEMPT ORG. TAX REV. 250 (2000). See also Carolyn D. Wright, UCC, IRS Settle Decade-Long Exemption Dispute: 501(c)(3) Status Revoked for Three Years, 28 EXEMPT ORG. TAX REV. 189 (2000).

⁸⁵ Treas. Reg. § 53.4958-4(a)(3). The Preamble to the final Regulations makes clear that this was added specifically because of the United Cancer Council decision. See 67 Fed. Reg. 3076, 3079-80 (Jan. 23, 2002).

⁸⁶ Special Committee on Exempt Organizations, New York State Bar Ass'n Tax Section, Comment on Treasury Foundation Report, in ADDITIONAL WRITTEN STATEMENTS . . . ON TREASURY DEPARTMENT REPORT ON PRIVATE FOUNDATIONS (Comm. Print, Committee on Ways and Means, U.S. House 710-35) (1965), quoted in John G. Simon, The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 67, at 89 (Walter W. Powell, ed., 1987). The problems of an all-or-nothing regime had also been noted by Congress. For example, the legislative history of the Omnibus Budget Reconciliation Act of 1987 observed that the IRS might “hesitate to revoke the exempt status of a charitable organization . . . in circumstances where that penalty may seem disproportionate.” H.R. Rep. No. 391, 100th Cong., 1st Sess., pt. 2, at 1623-24.

foundations put in place, for the first time, a more measured regimen of sanctions: tiers of excise taxes to be imposed on various sorts of sins.⁸⁷ It applied, however, only to private foundations,⁸⁸ thus leaving other charitable organizations⁸⁹ under the pre-existing all-or-nothing system.

Between 1969 and the early 1990s, there were occasional expressions of interest in applying some form of “intermediate sanctions” to public charities. For example, a 1989 report of an IRS Task Force on Civil Tax Penalties contains an extensive discussion of the private-foundation rules, including a policy analysis of the reasons why some or all of the chapter 42 rules might be applied to public charities. Its recommendations include this sentence: “The types of sanctions imposed on private foundations should be extended to some or all public charities with respect to self-dealing, excess business holdings, and taxable expenditures.”⁹⁰

In his opening statement at a June 15, 1993, hearing on public charities, Congressman J.J. Pickle, then-Chairman of the Oversight Subcommittee of the House Ways and Means Committee, made clear that he intended to consider legislation which would estab-

⁸⁷ Chapter 42 of the Code, §§ 4940-48, contains sections imposing excise-tax sanctions on self-dealing, failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures. See generally BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* § 11.4 (8th ed. 2003); FRANCIS R. HILL & DOUGLAS M. MANCINO, *TAXATION OF EXEMPT ORGANIZATIONS* ¶¶ 10.01 – 12.04 (2002); BRUCE R. HOPKINS & JODY BLAZEK, *PRIVATE FOUNDATIONS: TAX LAW AND COMPLIANCE* §§ 4.1 – 10.8 (2d ed. 2003).

⁸⁸ As defined in § 509.

⁸⁹ Private foundations are a subset of § 501(c)(3) organizations. There are many entities that are charitable under § 501(c)(3) but that are not private foundations. It is common to refer to them as “public charities.” In 1999, there were 62,694 private foundations reporting to the I.R.S. Melissa Ludlum, *Domestic Private Foundations and Charitable Trusts, 1999*, SOI BULLETIN, Fall 2002, at 136. In the same year, the I.R.S. counted a total of 637,351 “active” § 501(c)(3) organizations. Paul Arnsberger, *Charities and Other Tax-Exempt Organizations, 1999*, SOI BULLETIN, Fall 2002, at 122. By subtraction, there were nearly 575,000 public charities, in 1999, to which the chapter 42 excise tax rules did not apply. Put another way, there were approximately ten times as many public charities, immune from the chapter 42 rules, as there were private foundations subject to those rules. These data do have weaknesses, but a discussion of the problems is beyond the scope of this paper. See, e.g., *Appendix A: Methods and Definitions*, in DAVID R. STEVENSON, THOMAS H. POLLAK, & LINDA M. LAPKIN, *STATE NONPROFIT ALMANAC 1997: PROFILES OF CHARITABLE ORGANIZATIONS* 351-61 (1997).

⁹⁰ EXECUTIVE TASK FORCE, COMMISSIONER’S PENALTY STUDY, REPORT ON CIVIL TAX PENALTIES at IX-41 (Internal Revenue Service Feb. 22, 1989). That particular recommendation was *not* implemented when the rest of the Task Force suggestions were largely adopted in the Improved Penalty Administration and Compliance Tax Act (“IMPACT”), Pub. L. No. 101-239, 103 Stat. 2388 (1989). There had been one prior instance of using intermediate sanctions to police the actions of public charities: in 1987, Congress imposed excise tax penalties on public charities which made improper political expenditures. § 10712(a) of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987), adding § 4955 to the Code.

lish intermediate sanctions on public charities.⁹¹ In her testimony at that hearing, then-IRS Commissioner Margaret Richardson said in part:

“The lack of a sanction short of revocation of exemption in cases in which an organization violates the inurement standard or one of the other standards for exemption causes the Service significant enforcement difficulties. Revocation of an exemption is a severe sanction that may be greatly disproportional to the violation in issue. For example, assume that an examination of a large university reveals that the university is providing its president with inappropriate benefits. The university may be paying the president a salary that appears excessive in comparison to that paid to presidents of comparable universities. Alternatively, the university may have provided the president with a substantial interest-free loan. It may have paid for costly and luxurious amenities in the president’s official residence. Each of these facts would raise serious inurement questions. Revoking the university’s exemption, however, may be an inappropriate penalty. Revocation could adversely affect the entire university community — employees, students, and area residents. Moreover, even if the organization’s exemption were revoked, the president would be able to retain the benefits inappropriately received from the university. In short, the Service may be faced with the difficult choice of revoking an organization’s exemption or taking no enforcement action as long as the compensation in question has been reported accurately on the individual’s income tax return.”⁹²

The example given is compelling. Revocation would punish the innocent, disrupting many important relationships and expectations. It would have little or no impact on the recipient of the inurement. Commissioner Richardson concluded, “it would be useful to provide the Service with a sanction short of revocation to address violations of these standards.”⁹³

⁹¹ Federal Tax Laws Applicable to the Activities of Tax-Exempt Charitable Organizations: Hearing Before the Subcomm. on Oversight of the House of Representatives Comm. on Ways and Means, 103d Cong. 6, 7 (1993) [hereinafter June 15, 1993 Hearing] (statement of Chairman Pickle).

⁹² June 15, 1993 Hearing, *supra* note 91, at 14, 18-19 (1993) (prepared statement of Hon. Margaret Milner Richardson, Commissioner of Internal Revenue).

⁹³ *Id.* at 19.

Shortly after the June 15th hearing, the nonprofit sector acted aggressively to become involved in the process. In part that was due to the perception that Chairman Pickle appeared to be ready to move things forward; better to join (and attempt to influence) the course of the march than to be left standing at the start. Another important motive, however, was more expansive and less self-defensive: some of the major umbrella organizations — Independent Sector⁹⁴ in particular — believed that more accountability was desirable for the long-run health of the field, and that some form of intermediate sanctions would make that possible. As early as July of 1993, IS publicly stated that it “supports establishing intermediate sanctions, such as perhaps a 5% excise tax applicable to organizations and individuals, for acts of inurement or private benefit, provided that clear and reasonable definitions are developed for those acts.”⁹⁵

Sometime between the middle of August and early September of 1993, counsel for IS had his first conversation on this topic with an Attorney Advisor in the Treasury Department’s Tax Legislative Counsel’s office. IS counsel stated the view that the private foundation self-dealing rules were not an appropriate model for public charity intermediate sanctions, and urged the use of an arms-length standard instead.⁹⁶ The quick agreement to that principle by the Attorney Advisor paved the way to an ongoing constructive dialog with the Treasury.⁹⁷

⁹⁴ As its press releases often describe it, Independent Sector, founded in 1980, is a nonprofit coalition of over 850 corporate, foundation, and voluntary organization members with a national interest in voluntary action and philanthropy. Since its founding, it states, “we have supported openness, accountability and accessibility as basic to nonprofit behavior.” Press release, July 27, 1993, reprinted at 9 EXEMPT ORG. TAX REV. 151 (1994) (hereinafter *IS July 27 Press Release*). It is probably the largest umbrella organization of § 501(c)(3) and § 501(c)(4) organizations, and is clearly the most active in following and attempting to influence federal legislative and regulatory policies affecting its members. For many years, including those here in question, the author was a member of its Government Relations Committee. Independent Sector will sometimes hereinafter be referred to as “IS.”

⁹⁵ *IS July 27 Press Release*, *supra* note 94.

⁹⁶ In some instances, the self-dealing provisions — which adopt a set of prophylactic rules — penalize even a transaction which is beneficial to the charitable organization. See, e.g., § 4941(d)(1), treating as self-dealing any “sale or exchange” between a private foundation and a disqualified person. As the regulations confirm, “it is immaterial whether the transaction results in a benefit or a detriment to the private foundation.” Treas. Reg. § 53.4941(d)-1(a). Accord, Treas. Reg. § 53.4941(d)-2(a)(1) (“The sale or exchange of property between a private foundation and a disqualified person shall constitute an act of self-dealing . . . regardless of the amount paid to the disqualified person . . .”).

⁹⁷ Oct. 2, 1997, letter to the author from Robert A. Boisture (on file with the author). Mr. Boisture, a partner at Caplin & Drysdale in Washington, D.C., was one of the principal IS representatives on the intermediate sanctions project.

On September 20, 1993, the head of the IS Government Relations function, Bob Smucker, met with Beth Vance, the then-Staff Director of the Subcommittee on Oversight, to discuss intermediate sanctions legislation. In a September 29 letter following up on that meeting, Mr. Smucker confirmed IS's support for such legislation, and set forth five principal characteristics it should have:

1. Graduated penalty taxes should apply to unreasonable compensation and non-fair-market-value transactions involving public charities;
2. Intermediate sanctions should not adopt the self-dealing or mandatory payout rules from the 1969 private foundations legislation;
3. What is reasonable compensation should be determined under "the market-driven standard of current law";
4. The sanctions should be imposed on the individual malefactors rather than the public charities, but officers and directors should also be sanctioned if they "knowingly and willfully approve a prohibited transaction"; and
5. Appropriate safe harbors and de minimis rules should be adopted "to ensure that [the new sanctions] are not unduly burdensome, particularly to smaller charities."⁹⁸

A copy of the letter was sent to the Assistant Secretary of the Treasury for Tax Policy.

By early November of 1993, IS had prepared draft legislation and a 22-page explanation.⁹⁹ These were shared with relevant officials on the Staff of the Joint Committee on Taxation.¹⁰⁰ At the same time, efforts were taken to enlist the support of other nonprofit groups. For example, on Jan. 10, 1994, the President of the Council on Foundations wrote to Chairman Pickle, on behalf of the Council, to endorse the proposal for intermediate sanctions as drafted and submitted by IS.¹⁰¹

It seems fair to conclude, then, that the ultimate enactment of § 4958 was due in large part to the energetic efforts of the nonprofit sector itself, acting through some of its major umbrella organizations. It is easy to confirm this. Assistant Secretary of the Treas-

⁹⁸ Sept. 29, 1993, letter to Beth Vance from Robert Smucker (on file at Independent Sector).

⁹⁹ Copies of drafts of the legislation and the explanatory memorandum are on file at Independent Sector, the offices of its counsel (Caplin & Drysdale), and with the author.

¹⁰⁰ Nov. 19, 1993, letter (and enclosures) to Steve Arkin from Robert Boisture (on file at Caplin & Drysdale and with the author).

¹⁰¹ Jan. 10, 1994, letter from James A. Joseph to Hon. J.J. Pickle (copy on file with the author).

ury Leslie B. Samuels testified on March 16, 1994, at the third hearing on intermediate sanctions before the Oversight Committee. He explicitly recognized the contribution of IS in the development of the legislation:

“These types of [abuse] cases have shaken the public’s confidence in charitable organizations. Consequently, charities should be interested in reducing the occurrence of abuses, to prevent the further erosion of the reputation of the charitable community as a whole. In recognition of this fact, at least one large coalition of nonprofit organizations, INDEPENDENT SECTOR, has made proposals to improve the performance and accountability of public charities.”¹⁰²

*Interpretation of § 4958*¹⁰³

Given the policy behind § 4958, it should be interpreted so far as possible to be precisely congruent with the scope of the inurement proscription.¹⁰⁴ Whenever prohibited inurement can occur without violating § 4958, the only sanction continues to be revocation of tax-exempt status. It was exactly that undesirable situation that led to the enactment of intermediate sanctions. The legislative history can be read to confirm the view that § 4958 should duplicate the reach of the anti-inurement rules. The report of the House Ways and Means Committee first states that § 4958 may be applied either “in lieu of (or in addition to) revocation of an organization’s tax-exempt status.”¹⁰⁵ The accompanying footnote, however, goes on to say:

“In general, the intermediate sanctions are the *sole* sanction imposed in those cases in which the excess benefit does not rise to the level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization. In practice, revocation of tax-exempt status, with or without

¹⁰² U.S. Department of the Treasury’s Proposals to Improve Compliance by Tax-Exempt Organizations, Hearing Before the Subcomm. on Oversight of the House of Representatives Comm. on Ways and Means, 103d Cong. 16, 17 (1994) (prepared statement of Hon. Leslie B. Samuels, Assistant Secretary of the Treasury) (capitalization in original).

¹⁰³ For a comprehensive discussion of § 4958, see BRUCE R. HOPKINS, *THE LAW OF INTERMEDIATE SANCTIONS: A GUIDE FOR NONPROFITS* (2003).

¹⁰⁴ More precisely, § 4958 should be interpreted, if possible, to cover all situations in which prohibited inurement occurs. This principle would be preserved even if § 4958 also applied in other situations that would not constitute inurement. In other words, it would be acceptable for § 4958 to subsume inurement without necessarily being congruent or confined to it.

the imposition of excise taxes, would occur only when the organization no longer operates as a charitable organization.”¹⁰⁶

If, as the footnote urges, § 4958 generally displaces the inurement prohibition, that section also should aspire to cover the same transactions; otherwise, lacunae will occur.¹⁰⁷

The argument here is not for precise overlap of § 4958 with the anti-inurement rules. The statute unfortunately will not permit that construction. Rather, the suggestion is for congruent interpretation *so far as possible*. This proposition will be analyzed in three steps:

First — Certain types of transfers, although potentially subject to the anti-inurement regime, will not be caught by the new intermediate-sanctions provisions. The easiest example involves a payment of excess benefits to an “insider” by a private foundation. Because private foundations are explicitly excluded from the coverage of § 4958,¹⁰⁸ inurement transactions involving them will escape its claws.¹⁰⁹

Another example has been suggested. It rests on some statements in G.C.M. 39,862 to the effect that all doctors (and indeed all employees) are, for purposes of the inurement doctrine, “insiders” of the hospital where they work.¹¹⁰ If those statements are correct, excessive payments to such doctors or employees would fall afoul of the anti-inurement doctrine even if the recipients were not “in a position to exercise substantial influence over the affairs of the organization.” Such payments would *not*, however, be

¹⁰⁵ H.R. Rep. No. 104-506, at 59 (1996).

¹⁰⁶ *Ibid.*, n.15 (emphasis added).

¹⁰⁷ The possible overlap between revocation of exempt status and invocation of § 4958 is further discussed in the text accompanying notes 125 through 130 below.

¹⁰⁸ § 4958(e) states that “the term ‘applicable tax-exempt organization’ . . . shall not include a private foundation (as defined in section 509(a)).”

¹⁰⁹ In most instances, such transactions will be subject to a different excise tax regime: the self-dealing rules of § 4941. That will not *always* be the case, however. For example, “substantial contributors” are “disqualified persons” for purposes of § 4941, whereas § 4958 includes only persons “in a position to exercise substantial influence” within its own separate definition of “disqualified person.” Compare §§ 4946(a)(1)(A) and 4958(f)(1)(A). If someone with “substantial influence” does not appear within the class of “disqualified persons” defined in § 4946(a)(1), neither § 4958 nor § 4941 will apply if the organization in question is a private foundation. It is less clear whether there are also situations in which the substance of the benefit might constitute an excess benefit transaction but not fall within the § 4941 self-dealing rules.

¹¹⁰ G.C.M. 39,862 (Nov. 22, 1991) says that “all persons performing services for an organization . . . possess the requisite relationship to find inurement.” Read literally, that would include volunteers and independent contractors as well as employees.

subject to § 4958 sanctions because the recipients would not be “disqualified persons” as defined.¹¹¹ It seems clear, however, that those statements from the G.C.M. are wrong.¹¹² In its report on G.C.M. 39,862, the New York State Bar Association Tax Section argued that a janitor, for example, should *not* be treated as an insider.¹¹³ Subsequently, the then-Associate Chief Counsel of the Service, referring to that portion of the Bar Association Report, said, “I understand the concern. We intend to clarify that issue in an upcoming GCM.”¹¹⁴

The legislative history of § 4958 also casts doubt on those over-broad statements from G.C.M. 39,862:

“The IRS has issued a general counsel memorandum indicating that all physicians are considered ‘insiders’ for purposes of applying the private inurement proscription. The Committee intended that physicians will be disqualified persons only if they are in a position to exercise substantial influence over the affairs of an organization.”¹¹⁵

Furthermore, the Service has acknowledged that the over-broad statements in G.C.M. 39,862 are inaccurate. In its so-called physician-recruitment ruling, it stated:

“The physicians described in the following recruiting transactions do not have substantial influence over the affairs of the hospitals that are recruiting them. Therefore, they are not disqualified persons as defined in § 4958, nor do they have any

¹¹¹ § 4958(f)(1)(A) defines “disqualified person” as “any person . . . in a position to exercise substantial influence over the affairs of the organization.” Thus, doctors or employees who lack such influence would not generally be covered by § 4958. This is confirmed by Treas. Reg. § 53.4958-3(g), Example 10.

¹¹² Interestingly, G.C.M. 39,862 (Nov. 22, 1991) contains a quite correct and useful definition: “The proscription against inurement generally applies to a distinct class of private interests — typically persons who, because of their particular relationship with an organization, have an opportunity to control or influence its activities.” It is only later in its text that it erroneously ignores that definition and suggests that all employees and doctors are “insiders” without regard to their influence over the organization.

¹¹³ *New York State Bar Ass’n Report on G.C.M. 39,862*, note 77 above, 6 EXEMPT ORG. TAX REV. at 1400 (1992).

¹¹⁴ *McGovern 1993 Talk*, note 68 above, 7 EXEMPT ORG. TAX REV. at 555. No such clarifying G.C.M. has emerged. See, however, the text accompanying note 116 below.

¹¹⁵ H.R. Rep. No. 104-506, at 58 n. 12 (1996). The footnote does not, of course, indicate whether the G.C.M. is a correct statement of law for non-§ 4958 purposes.

personal or private interest in the activities of the organizations that would subject them to the inurement proscription of § 501(c)(3).”¹¹⁶

This also confirms that employees and doctors who lack actual influence will *not* be treated as insiders.

The most definitive rejection of the overbroad statements in G.C.M. 39,862 came in the regulations under § 4958. Certain employees of an applicable tax-exempt organization are explicitly excluded from the from the class of disqualified persons.¹¹⁷ It follows that the second example, above, of inurement rules applying when § 4958 does not is incorrect. It is clear that the over-broad statements from G.C.M. 39,862 were wrong.

Second — Conversely, there will be cases in which only § 4958, and not the inurement proscription, will apply.¹¹⁸ As one example, § 4958(f)(1)(A) defines a “disqualified person” to include anyone who had the requisite control “at any time during the 5-year period ending on the date of such [excess-benefit] transaction.” There is no known precedent that invokes any such look-back rule for purposes of the anti-inurement provisions. Other examples could easily be provided. For instance, by application of the attribution or affiliation rules in § 4958,¹¹⁹ a limited partnership in which a step-brother of an insider’s spouse owns a 36% “silent” profits interest automatically becomes a disqualified person for purposes of § 4958, even if there is no evidence whatsoever of that partnership (or the step-brother) being in a position to exercise any control over the nonprofit organization in question and even if the step-brother is in fact hated by both the insider and the spouse-sibling.¹²⁰

¹¹⁶ Rev. Rul. 97-21, 1997-1 C.B. 121.

¹¹⁷ See Treas. Reg. §§ 53.4958-3(d)(3) and 53.4958-3(g), Examples 1, 9, and 10.

¹¹⁸ As noted above, at n. 104, as long as § 4958 is interpreted, so far as possible, to cover all situations involving inurement, there is no problem in principle if it also applies in other situations.

¹¹⁹ §§ 4958(f)(1)(B), 4958(f)(3)(A)(ii), and 4958(f)(4).

¹²⁰ Of course, sound tax administrators should, and probably would, prevent any such case from being pursued under § 4958. In other contexts, family hostility has generally (but with a few older precedent exceptions) been held not to mitigate against the strict application of attribution rules in the Code. See, e.g., David Metzger Trust v. Commissioner, 693 F.2d 459 (5th Cir. 1982), cert. denied, 463 U.S. 1207 (1983); Michael N. Cerone v. Commissioner, 87 T.C. 1 (1986); Rev. Rul. 80-26, 1980-1 C.B. 66. See generally BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 9.02[2] (7th ed. 2000).

A final possible example of the reach of § 4958 exceeding that of the anti-inurement doctrine involves attempts to justify certain types of apparent excess benefit as being merely reasonable compensation for services performed by the insider. The statute and the regulations are explicit that, for purposes of the excess-benefit regime, any such justification must be shown by *contemporaneous* — rather than *ex post* — written evidence.¹²¹ By contrast, it is possible, albeit not certain, that an *ex post* argument, attempting to justify an apparent inurement transaction as constituting reasonable compensation for services rendered, might be accepted by the Courts.¹²²

Third — Thus, in conclusion, while the provisions overlap, each also has its own independent area of effectiveness; neither is a subset of the other. The argument, then, is that the § 4958 rules should cover inurement situations as much as possible, i.e., that as few lacunae as possible should exist where the inurement doctrine applies but § 4958 does not.

The examples, above, of non-overlap cases involve either the status of the recipient of the proscribed benefit or the status of the charity transferring it. In the first example, the charity was a private foundation, explicitly excluded from the operation of the intermediate sanctions legislation.¹²³ In the second example, the recipient was a person who, while not an actual “insider” for purposes of the inurement prohibition, was explicitly included within the “disqualified person” category of § 4958 as a result of its attribution or affiliation rules.¹²⁴ The argument for common interpretation, then, comes to this: the *substance* of a transaction — whether it constitutes inurement or an excess benefit — should

¹²¹ § 4958(c)(1)(A); Treas. Reg. §§ 53.4958-1 and -4(c)(3). See also H. Rep. No. 506, 104th Cong., 2d Sess. 57 n. 8 (1996). A “reasonable cause” exception is provided by the regulations. Treas. Reg. § 53.4958-4(c)(3)(i)(B). Under no circumstances may an excess benefit resulting from fraud or theft be justified as compensation, regardless of the existence of any contemporaneous evidence. Treas. Reg. § 53.4958-4(c)(1).

¹²² There is precedent to the contrary, however, suggesting that *ex post* justifications may not be accepted. In Founding Church of Scientology v. United States, 412 F.2d 1197, 1202 (Ct. Cl. 1969), the Court rejected an *ex post* attempt to justify inurement saying, “If in fact a loan or other payment in addition to salary is a disguised distribution or benefit from the net earnings, the character of the payment is not changed by the fact that the recipient’s salary, if increased by the amount of the distribution or benefit, would still have been reasonable.” In John Marshall Law School v. United States, 81-2 U.S.T.C. ¶ 9514 (Ct. Cl. 1981) (Trial J. decision), adopted by the Court, 81-2 U.S.T.C. ¶ 9745 (Ct. Cl. 1981), the Court followed the Founding Church of Scientology decision, quoting with approval the language, above.

¹²³ See text accompanying notes 108 and 109 above.

¹²⁴ See text accompanying notes 119 and 120 above.

be interpreted identically for purposes of both doctrines, even though the *status* issues, i.e., the status of either the person benefited or the charity making that payment, may have to be interpreted differently.

At first glance, it might seem that there would be little incentive to argue for § 4958 *not* being co-extensive with the scope of the inurement proscription: why would any organization risk loss of exempt status rather than the imposition of a fine on its disqualified persons? The litigation posture, however, will be different than that. § 4958 imposes its sanctions on the individual beneficiaries of excess benefit transactions, not on the entity involved.¹²⁵ They will argue against the imposition of excise taxes, perhaps caring little whether the exemption of the charitable organization in question would be put at risk. It might be tempting for diligent government litigators to assert parallel claims — one against the individuals under § 4958 and another against the organization under § 501(c)(3). The temptation should be resisted in most instances. Succumbing to it would violate the Congressional intention that § 4958 usually be the exclusive remedy,¹²⁶ and it would needlessly create litigation costs (both time and money) for the public charity. The Service should adopt¹²⁷ and publicly announce a policy of using *only* § 4958 to police inurement violations except in extreme cases.¹²⁸

Although the Treasury Department had indicated, in the preamble to the 1998 Proposed Regulations under § 4958, that this would be the position taken final regulations,¹²⁹ the Temporary Regulations promulgated in early 2001 took a different tack. They backed off the earlier undertaking, saying instead:

¹²⁵ §§ 4958(a) and (b). This was one of the “first principles” urged by Independent Sector more than three years before the final enactment of § 4958. See text accompanying note 98 above.

¹²⁶ See text accompanying note 106 above.

¹²⁷ In TAM 200437040 (June 7, 2004), the Service did support the imposition of intermediate sanctions without also seeking revocation of exemption. The memorandum does not include any rationale for this, stating merely: “[s]ince certain expenditures have been taxed as automatic excess benefits under Section 4958, revocation of exemption is not appropriate here.”

¹²⁸ The Congressional injunction was to use only § 4958 except in situations in which the inurement abuse is so substantial that “it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization.” The text of the entire footnote from which the preceding quotation is taken appears in the text accompanying note 106 above. See also MARION FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 262-64 (2004); BRUCE R. HOPKINS, THE LAW OF INTERMEDIATE SANCTIONS: A GUIDE FOR NONPROFITS §§ 6.8(b) & (c) (2003).

¹²⁹ See the Preamble to the Proposed Regulations, 63 Fed. Reg. 41486, 41489 (Aug. 4, 1998).

“The temporary regulations do not foreclose revocation of tax-exempt status in appropriate cases. The IRS and the Treasury Department believe that to do so would effectively change the substantive standard for tax-exempt status under sections 501(c)(3) and (4). Accordingly, the IRS intends to exercise its administrative discretion in enforcing the requirements of sections 4958, 501(c)(3) and 501(c)(4) in accordance with the direction given in the legislative history. The IRS will publish guidance concerning the factors that it will consider in exercising its discretion as it gains more experience administering the section 4958 regime.”¹³⁰

In the first case decided under § 4958, the I.R.S. argued for *both* the imposition of intermediate sanctions *and* revocation of exempt status. The Tax Court sustained the imposition of excise taxes on the disqualified persons, but it declined to accept the revocation argument.¹³¹ The Court first noted that “[a]lthough the imposition of section 4958 excise taxes as a result of an excess benefit transaction does not preclude revocation of the organization’s tax-exempt status, the legislative history indicates that both a revocation and the imposition of intermediate sanctions will be an unusual case.”¹³² The Court then refused to revoke the organization’s tax exemption for three reasons: (1) the excess benefit transaction in question was a “single transaction,”¹³³ (2) the charities — since the transaction in question — had not “been operated contrary to their tax-exempt purpose,” and (3) there was “some credence in petitioners’ suggestion that maintenance of the tax exemption may enable them to utilize the correction provisions made available in sections 4961 through 4963.”¹³⁴

¹³⁰ Preamble to the Temporary Regulations, 66 Fed. Reg. 2144, 2155 (Jan. 10, 2001). See also the first sentence of Treas. Reg. § 53.4958-8(a) and the Preamble to the final Regulations, 67 Fed. Reg. 3076, 3082 (Jan. 23, 2002).

¹³¹ Caracci v. Commissioner, 118 T.C. 379 (2002).

¹³² Id. at 417.

¹³³ Id. at 418. This observation presumably suggests that the excess benefit in question did not “rise to a level where it calls into question whether, on the whole, the organization functions as . . . charitable,” as per the footnote in the legislative history quoted in the text accompanying note 106, above.

¹³⁴ Id. at 418. The third point above — maintaining tax exemption to permit correction — seems dubious in light of Treas. Reg. § 53.4958-7(e)(2) permitting correction to occur by paying the correction amount to *another* properly-selected charitable organization if the tax exempt status of the first organization has been terminated.

It is hoped the I.R.S. will publish guidance on this issue soon.¹³⁵ Doing so will assist counsel in guiding their exempt clients into appropriate compliance with good practices in order to avoid revocation of exempt status following the occurrence of an excess benefit transaction.

Although § 4958 was signed into law on July 30, 1996, it was made effective retroactively: it applies generally to excess benefit transactions occurring on or after Sept. 14, 1995.¹³⁶ It has thus been in force for more than nine years. Regulations were first proposed in 1998; Temporary Regulations were adopted in January of 2001; and final Regulations were adopted in January of 2002.¹³⁷ In addition to the one litigated case discussed above,¹³⁸ the excess-benefit rules have been successfully applied in several other instances.¹³⁹ The Service can and should continue to assert these excess-benefit excise taxes vigorously in appropriate cases. Doing so will help to develop more coherent and rational legal precedents dealing with issues of inurement.

Tax Consequences of “Correction”

Two penalty excise taxes are imposed on an insider who receives an excess benefit: a first-tier tax of 25% of the amount of the benefit,¹⁴⁰ and — if the transaction is not timely “corrected” — a second-tier tax of 200% of the amount of the benefit.¹⁴¹ For this purpose, “correction” means “undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the

¹³⁵ In July of 2004, the I.R.S. Assistant Chief Counsel, Tax Exempt and Government Entities, noted that a new “priority” project for the I.R.S.’s guidance plan for 2004-05 would address the circumstances under which the Service will pursue only § 4958 remedies, only revocation of exemption, or both. Fred Stokeld, Guidance to Address Revocation, Excise Taxes, Says I.R.S. Official, 45 EXEMPT ORG. TAX REV. 323 (2004).

¹³⁶ § 1311(d)(1) of the Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996). A binding-written-agreement exception to this retroactive effective date was provided in § 1311(d)(2). See generally Treas. Reg. § 53.4958-1(f).

¹³⁷ T.D. 8978, 67 Fed. Reg. 3076 (Jan. 23, 2002).

¹³⁸ Caracci v. Commissioner, discussed in the text accompanying notes 131 - 134, above.

¹³⁹ See the situations discussed in MARION FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 260-62 (2004), and see also TAMs 200435018 through 200435022, each dated May 5, 2004, imposing both first- and second-tier sanctions (the amounts of which are redacted) on the founder of a charitable organization, his spouse, his two sons, and his son-in-law for various excess-benefit transactions involving the founder’s church. The most recent application is TAM 200437040 (June 7, 2004), described at n. 127, above.

¹⁴⁰ § 4958(a)(1). Under certain circumstances, even the first-tier tax may be abated, per §§ 4962(a) and 4963(a).

highest fiduciary standards.”¹⁴² Thus, the statute inflicts some pain to punish the infraction and much more severe pain if it is not reversed.

It is perfectly clear that the insider may take no deduction for either the first- or second-tier excise taxes.¹⁴³ It is less clear what the tax treatment is of any amounts returned to the organization as “correction.” Several possibilities exist:

- The amounts might be deductible,
- The amounts might be subject to special beneficial rules of § 1341, or
- The amounts might be nondeductible.

The proper treatment of correction amounts depends on the nature of the excess benefit transaction.

If the excess benefit occurs as the result of theft or fraud, e.g., through embezzlement, it is clear that the disqualified person is entitled to a deduction when the funds are returned.¹⁴⁴ It is equally clear that the special mitigating relief provisions of § 1341 are not available because one of the preconditions to the applicability of that section — that the funds were originally received under some claim of right¹⁴⁵ — cannot be met.¹⁴⁶

On the other hand, if the excess benefit occurs as the result of a more benign transaction, such as overly-generous compensation, in most cases, under existing precedent, no deduction will be available for payments in “correction.” That is because “[d]eductions for repayment of amounts received under claim of right have been denied in cases where the repayment is not required by either express contractual provisions or applicable legal principles.”¹⁴⁷ In such cases, § 1341 relief will also be unavailable.¹⁴⁸

There are, however, three legal theories that possibly might permit a deduction for returned excess compensation in § 4958 situations. First, an argument can be made that the looming threat of a 200% second-tier excise tax creates the equivalent of a legal obli-

¹⁴¹ § 4958(b).

¹⁴² § 4958(f)(6).

¹⁴³ § 275(a)(6).

¹⁴⁴ § 165(c)(2); Rev. Rul. 65-254, 1965-2 C.B. 50.

¹⁴⁵ § 1341(a)(1).

¹⁴⁶ Rev. Rul. 65-254, 1965-2 C.B. 50.

¹⁴⁷ Harold Dubroff, The Claim of Right Doctrine, 40 TAX L. REV. 729, 753 (1985).

gation to repay the excess benefit.¹⁴⁹ If that argument is accepted, a deduction would be available and the provisions of § 1341 might also apply.¹⁵⁰ Second, an argument can be made that, in the absence of legal compulsion, the return of the excess benefit constitutes a charitable contribution. This second argument (1) is inconsistent with the compulsion theory of the first argument, (2) may fail the test of the regulations that a charitable contribution must have been intended,¹⁵¹ and (3) even if successful would produce a more limited deduction than the first argument.¹⁵² Third, it may occasionally be possible to argue for a deduction if the taxpayer's motive for making the payments was to protect his job.¹⁵³

A self-help method exists for ameliorating these harsh results: the charitable entity may adopt a legally-enforceable by-law, or enter into a contract with the taxpayer receiving compensation, prior to the transaction¹⁵⁴ obligating the disqualified person to return any amounts determined to constitute an excess benefit. Such a by-law or contract creates an enforceable obligation to repay such amounts, and that legal obligation makes a deduction available.¹⁵⁵ The Service has taken the view, however, that — even when such a contract is in place — the special mitigating relief provisions of § 1341 are not available,¹⁵⁶ but at least one court has disagreed.¹⁵⁷ Consideration should be given to adopting such a by-law or entering into such agreements covering all excess benefit transactions with all disqualified persons. The existence of a deduction, and perhaps the additional benefit of § 1341 treatment, will make it even more likely that excess benefits are returned to the or-

¹⁴⁸ E.g., Blanton v. Commissioner, 46 T.C. 527 (1966), aff'd per curiam, 379 F.2d 558 (5th Cir. 1967) (no § 1341 relief even when repayment was made pursuant to binding contract because the contract was entered into subsequent to the original payment).

¹⁴⁹ At the very least, it would not be embarrassing to proffer this argument.

¹⁵⁰ See the discussion in the text, below, accompanying notes 156 and 157.

¹⁵¹ Treas. Reg. § 1.170A-1(h)(1)(i). Cf. Rev. Rul. 79-148, 1979-1 C.B. 93 (no deduction for payment to charity as a condition of probation).

¹⁵² See, e.g., §§ 170(b), (d), (e), and (f).

¹⁵³ See, e.g., Gould v. Commissioner, 64 T.C. 132 (1975); Conley v. Commissioner, 36 T.C.M. (CCH) 1644 (1977).

¹⁵⁴ The agreement must be in place in advance of the excess benefit transaction to make the deduction available. Pahl v. Commissioner, 67 T.C. 286 (1976).

¹⁵⁵ Oswald v. Commissioner, 49 T.C. 645 (1968), acq.; Rev. Rul. 69-115, 1969-2 C.B. 50.

¹⁵⁶ Rev. Rul. 69-115, 1969-2 C.B. 50.

¹⁵⁷ Eugene Van Cleave v. United States, 718 F.2d 193 (6th Cir. 1983).

ganization in question, which is the fundamental policy behind the intermediate sanctions in § 4958.¹⁵⁸

Conclusion

Although the inurement proscription has been in the statute for nearly a century, there is very little authority helpfully interpreting it. The specific statutory language is of almost no help in marking out the scope of the rule; indeed, this paper argues that the words ought generally to be disregarded. To some extent, the paucity of precedent probably follows from the harshness of what long was the only available penalty: revocation of tax exemption. Because the intermediate sanctions legislation now provides a more measured remedy, and because the substantive scope of § 4958 should be interpreted to be closely identical to the anti-inurement doctrine, there is reason to hope that better guidance will emerge in the months and years ahead. That is a consummation devoutly to be wished, because of the critical importance to this country of the work of its charitable community and the consequent importance of making sure that charity's quintessential nature is protected and polished — that is, that charitable assets are deployed only for the benefit of the intended beneficiaries and not to other persons, and that this is also seen to be the case as the result of an appropriate level of scrutiny and accountability.

¹⁵⁸ In addition, it seems clear that insuring disqualified persons against excise tax liability for excess benefit transactions is permissible and not against public policy. Both the legislative history, H.R. Rep. No. 506, 104th Cong., 2d Sess. 58 (1996), and the Treasury Regulations, Treas. Reg. § 53.4958-4(b)(ii)(B)(2)(i), contemplate such insurance, cautioning only that premiums paid by the organization will constitute compensation for purposes of determining whether aggregate compensation is reasonable.

Appendix A
General Counsel Memoranda
and
Revenue Rulings
on
Inurement, Private Benefit, and Excess Benefit Transactions

General Counsel Memoranda

1. G.C.M. 39,884 (Oct. 29, 1992).
2. G.C.M. 39,876 (July 29, 1992).
3. G.C.M. 39,873(Apr. 15, 1992).
4. G.C.M. 39,867 (Dec. 18, 1991).
5. G.C.M. 39,862 (Nov. 22, 1991).
6. G.C.M. 39,818 (May 10, 1990).
7. G.C.M. 39,817 (May 9, 1990).
8. G.C.M. 39,674 (Oct. 23, 1987).
9. G.C.M. 39,670 (Oct. 14, 1987).
10. G.C.M. 39,562 (Oct. 8, 1986).
11. G.C.M. 39,498 (Apr. 24 1986).
12. G.C.M. 39,414 (Sept. 25, 1985).
13. G.C.M. 38,905 (Oct. 6, 1982).
14. G.C.M. 38,827 (Mar. 23, 1982).
15. G.C.M. 38,821 (Feb. 3, 1982).
16. G.C.M. 38,638 (Feb. 20, 1981).
17. G.C.M. 38,459 (July 31, 1980).

18. G.C.M. 38,425 (June 30, 1980).
19. G.C.M. 38,322 (Mar. 24, 1980).
20. G.C.M. 38,283 (Feb. 15, 1980).
21. G.C.M. 37,789 (Dec. 18, 1978).
22. G.C.M. 37,596 (July 3, 1978).
23. G.C.M. 37,490 (Apr. 3, 1978).
24. G.C.M. 37,289 (Oct. 7, 1977).
25. G.C.M. 37,180 (June 24, 1977).
26. G.C.M. 37,065 (Mar. 25, 1977).
27. G.C.M. 37,030 (Mar. 3, 1977).
28. G.C.M. 36,918 (Nov. 11, 1976).
29. G.C.M. 36,902 (Oct. 29, 1976).
30. G.C.M. 36,539 (Dec. 29, 1975).
31. G.C.M. 36,435 (Sept. 23, 1975).
32. G.C.M. 36,253 (May 5, 1975).
33. G.C.M. 36,247 (Apr. 28, 1975).
34. G.C.M. 36,114 (Dec. 20, 1974).
35. G.C.M. 36,057 (Oct. 21, 1974).
36. G.C.M. 35,951 (Aug. 16, 1974).
37. G.C.M. 35,869 (June 21, 1974).
38. G.C.M. 35,865 (June 21, 1974).
39. G.C.M. 35,855 (June 17, 1974).
40. G.C.M. 35,771 (Apr. 9, 1974).

41. G.C.M. 35,719 (Mar. 11, 1974).
42. G.C.M. 35,638 (Jan. 28, 1974).
43. G.C.M. 35,586 (Dec. 10, 1973).
44. G.C.M. 35,234 (Feb. 7, 1973).
45. G.C.M. 35,210 (Jan. 26, 1973).
46. G.C.M. 34,796 (Mar. 2, 1972).
47. G.C.M. 34,437 (Feb. 19, 1971).
48. G.C.M. 34,325 (July 31, 1970).
49. G.C.M. 34,259 (Jan. 23, 1970).
50. G.C.M. 34,256 (Jan. 22, 1970).
51. G.C.M. 33,971 (Nov. 19, 1968).
52. G.C.M. 33,803 (Apr. 22, 1968).
53. G.C.M. 33,058 (Aug. 6, 1965).
54. G.C.M. 32,518 (Feb. 20, 1963).
55. G.C.M. 31,081 (Jan. 26, 1959).

Revenue Rulings

1. Rev. Rul. 97-21, 1997-18 I.R.B. 8.
2. Rev. Rul. 89-74, 1989-1 C.B. 311.
3. Rev. Rul. 86-98, 1986-2 C.B. 74.
4. Rev. Rul. 85-175, 1985-2 C.B. 276.
5. Rev. Rul. 81-60, 1981-1 C.B. 335.
6. Rev. Rul. 81-127, 1981-1 C.B. 357.
7. Rev. Rul. 80-286, 1980-2 C.B. 179.

8. Rev. Rul. 80-130, 1980-1 C.B. 117.
9. Rev. Rul. 80-106, 1980-1 C.B. 113.
10. Rev. Rul. 78-232, 1978-1 C.B. 69.
11. Rev. Rul. 77-206, 1977-1 C.B. 149.
12. Rev. Rul. 77-70, 1977-1 C.B. 150.
13. Rev. Rul. 76-257, 1976-2 C.B. 52.
14. Rev. Rul. 76-38, 1976-1 C.B. 157.
15. Rev. Rul. 76-91, 1976-1 C.B. 149.
16. Rev. Rul. 76-441, 1976-2 C.B. 147.
17. Rev. Rul. 74-148, 1974-1 C.B. 138.
18. Rev. Rul. 73-313, 1973-2 C.B. 174.
19. Rev. Rul. 73-14, 1973-1 C.B. 117.
20. Rev. Rul. 73-126, 1973-1 C.B. 220.
21. Rev. Rul. 70-566, 1970-2 C.B. 128.
22. Rev. Rul. 70-48, 1970-1 C.B. 133.
23. Rev. Rul. 69-636, 1969-2 C.B. 126.
24. Rev. Rul. 69-383, 1969-2 C.B. 113.
25. Rev. Rul. 69-538, 1969-2 C.B. 116.
26. Rev. Rul. 69-545, 1969-2 C.B. 117.
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Appendix B

Leading Cases

on

Inurement, Private Benefit, and Excess Benefit Transactions

1. Airlie Found., Inc. v. United States, 826 F. Supp. 537 (D.D.C. 1993), *aff'd*, 55 F.3d 684 (D.C. Cir. 1995).
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Appendix C
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