

Private Benefit: What Is It – and What Do We Want It To Be?*

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I. Introduction

Beginning with the landmark decision *American Campaign Academy v. Commissioner*² in 1989, the Internal Revenue Service has used the “private benefit” doctrine as a primary tool to police the activities of charitable organizations exempt under Code Section 501(c)(3). Unfortunately, the doctrine literally has no doctrinal content. Unlike its sibling, the private inurement doctrine, the private benefit doctrine has no statutory basis in 501(c)(3). Though the IRS claims the doctrine flows from the 1959 Treasury Regulations, it is a claim that is questionable given the language used,³ and in any event, this interpretation of the regulations appears not to have been “discovered” until some at least a decade after the regulations were promulgated.⁴

The closest we have to an official definition of the doctrine comes from an IRS General Counsel’s Memorandum issued in 1987. This memorandum states, “An organization is not described in section 501(c)(3) if it serves a private interest more than incidentally A private benefit is considered incidental only if it is incidental in both a qualitative and quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals . . . to be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.”⁵ The problem with this “definition,” of course, is that it is a quintessential balancing test with no substantive limits

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² *American Campaign Academy v. Comm’r*, 92 T.C. 1053 (1989).

³ See text at notes 9-16, *infra*.

⁴ *Id.*

⁵ Gen. Couns. Mem. 39598 (Jan. 23, 1987).

and no guidance on exactly what a charity is supposed to balance. Terms such as “necessary concomitant” are useless; does “necessary” in this context mean the fabled “appropriate and helpful” that Justice Cardozo cribbed from constitutional law in explaining the test for deductible business expenses in *Welch v. Helvering*?⁶ Or does it literally mean “necessary” in the sense of “no other reasonable option”? When is a benefit not “substantial” in comparison to a public benefit? Do we measure that by monetary impact? Number of charitable beneficiaries served? Can an organization fighting for economic survival claim more leeway in private benefit transactions than one relatively well-off that may not need the transaction at issue to stay in business? Is it really impossible for the tax system to do better than resort to Justice Stewart’s famous “I know it when I see it” test?⁷

The next two sections of this paper explore these questions. Part II concerns itself with the history and current application of the doctrine. This section, I believe, will demonstrate that neither the courts nor IRS personnel know what “private benefit” means, and that there is no coherent doctrinal definition of the concept. Part III then turns to the normative questions. Do we need the private benefit doctrine at all? If so, why, when, and how do we give some substantive content to it?

II. History and Current Application

A. Early Development

Where does the “private benefit” doctrine come from? The answer is murky. Neither the current version of Section 501(c)(3) nor its historical antecedents have any reference to “private benefit.” The 1909 predecessor to Section 501(c)(3) of the Code contained a limitation that an organization qualified for exemption only if “no part of the

⁶ *Welch v. Helvering*, 290 U.S. 111 (1933).

⁷ *Jacobellis v. Ohio*, 378 U.S. 184 (1964).

profit of which inures to the benefit of any private stockholder or individual . . .”⁸ This “private inurement” language survives in slightly-altered form in today’s Section 501(c)(3), providing exemption only if “no part of the net earnings of which inures to the benefit of any private shareholder or individual.” Unlike private benefit, the private inurement limitation therefore has both a statutory basis and a clear doctrinal content: over the years, both court decisions and IRS interpretations have defined “inurement” as the “siphoning off” of charitable assets to insiders via non-arm’s-length transactions.⁹

Instead, the IRS finds the private benefit doctrine in Regulations Section 1.501(c)(3)-1(d)(1)(ii), which states, “An organization is not . . . [qualified for exemption] . . . unless it serves a public rather than private interest. Thus . . . it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled directly or indirectly, by such private interests.”¹⁰ Despite the IRS’s claims, however, this language arguably is little more than an augmented explanation of the statutory private inurement limitation. For example, when the regulation states that an exempt charity must not be “organized or operated for the benefit 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” it appears that the regulation is discussing mostly insiders of the organization: the creator, shareholders, or parties controlled by them. Indeed, the classic *ejusdem generis* maxim of statutory interpretation would call for the general term in this regulation (“private interests”) to be limited by the expression of the specific examples, which are “designated

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

⁹ See FRANCIS R. HILL AND DOUGLAS M. MANCINO, *TAXATION OF EXEMPT ORGANIZATIONS* ¶4.03 (2002); BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 428-30 (7th ed. 1998); *United Cancer Council v. Comm’r*, 165 F.3d 1173, 1176 (7th Cir. 1999) (“A charity is not to siphon its earnings to its founder, or the members of its board, or their families, or anyone else fairly to be described as an insider, that is, as the equivalent of an owner or manager.”); see also, Darryll K. Jones, *Private Benefit and the Unanswered Questions from Redlands Surgical Services*, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 Va. Tax Rev. 575, 595-610 (2000) (defining “strict accounting private inurement” as transactions in which assets of an exempt organization are siphoned off to insiders).

¹⁰ Treas. Reg. § 1.501(c)(3)-1(d)(2)(ii).

individuals, the creator and shareholders,” all words that seem to convey an insider relationship with the entity. Indeed, at least some court opinions from before 1980 appear to have substantially equated the concept of private benefit to private inurement. In *BHW Anesthesia Foundation v. Commissioner*,¹¹ for example, the Tax Court noted “Respondent has chosen not to base his position on the proscription against the net the net earnings of an organization inuring to the benefit of private individuals -- a separate requirement for qualification under sec. 501(c)(3). He instead relies on the common law prohibition against charitable organizations being operated for the profit or private benefit of its owners or operators. In any event, the two requirements appear to be substantially identical.”¹²

Other cases and rulings prior to the late 1970’s viewed private benefit as a restatement of the common law requirement that a charity must serve a broad charitable class. Under classic charitable trust principles, for example, a trust to maintain a public graveyard was considered charitable, but not one to maintain a individual’s private tomb.¹³ Similarly, a trust to maintain the home of a famous violinist was not charitable when the violinist’s daughter owned the home and thus would benefit directly from the maintenance expenditures.¹⁴ In Rev. Rul. 75-286,¹⁵ the IRS appeared to adopt this reading of private benefit, holding that an organization dedicated to improving one city block (and limiting its members to residents of that block) violated the private benefit prohibition because it did not serve a large enough class to be charitable, even though a few years earlier the Service had held that an organization devoted to beautifying an entire city would qualify.¹⁶

By the late 1970’s, however, the IRS had crystallized its view that private benefit was indeed a separate exemption doctrine from private inurement, and that the focus of private benefit was on economic benefits flowing to persons outside the charitable class

¹¹ *B.H.W. Anesthesia Foundation, Inc. v. Commissioner*, 72 T.C. 681 (1979).

¹² *Id.* at 685 n.3.

¹³ Restatement (Second) Of Trusts, § 374, Comment (h) (1959). *See also* the numerous cases cited in Austin W. Scott & William F. Fratcher, *The Law Of Trusts*, § 375.3 n.8 (4th ed. 1989).

¹⁴ *Thorp v. Lund*, 227 Mass. 474, 481-82, 116 N.E.2d, 946, 950 (1917).

¹⁵ 1975-2 C.B. 210.

¹⁶ Rev. Rul. 68-14, 1968-1 C.B. 243.

resulting from specific structures chosen arguably to serve the charitable class. This crystallization began with a series of cases in the health care area. For example, in *Harding Hospital v. United States*,¹⁷ the IRS argued that excessive private benefit resulted from the fact that the existence of the particular psychiatric hospital in question was necessary for the doctors to practice their special “milieu therapy” on patients. This argument focused not on the size of the charitable class, but rather on benefits flowing to other private individuals in serving the charitable class. The Sixth Circuit rejected this argument, but ultimately upheld revocation of exempt status on traditional private inurement grounds. Though ultimately unsuccessful, the IRS returned to this theme in a series of cases dealing with “medical practice plans” associated with exempt medical schools, arguing that these plans violated the private benefit doctrine because of the substantial monetary benefits to the doctors involved in the plan.¹⁸

The theme of private benefit as regulating benefits flowing to persons outside the charitable class as a result of operational decisions also surfaced in rulings issued by the Service during this time period. In Rev. Rul. 76-206,¹⁹ the Service held that a foundation that supported classical programming on an individual radio station was not charitable because the monetary support the foundation provided to the radio station was an excessive private benefit. In Rev. Rul. 76-152,²⁰ the IRS found that an art gallery dedicated to displaying and selling the work of a limited number of local artists who received 90% of the sales proceeds was also guilty of excessive private benefit. In both these cases, like the litigating position in *Harding Hospital*, the focus in the ruling was not

¹⁷ 505 F.2d 1068 (6th Cir. 1974).

¹⁸ The series of cases were *B.H.W. Anesthesia Foundation, Inc. v. Comm’r*, 72 T.C. 681 (1979); *University of Massachusetts Medical School Group Practice v. Comm’r*, 74 T.C. 1299 (1980); and *University of Maryland Physicians, P.A. v. Comm’r*, 41 T.C.M. 732 (1981). All these cases involved a common core of facts: in order to provide higher compensation levels to the teaching doctors at these medical schools, each had formed a “practice plan” that collected fees from the doctors’ private practice of medicine and then paid a certain portion of those fees back to the doctors as compensation. The IRS had argued in each case that the practice plan constituted nothing more than an organization collecting fees for the doctors, and hence excessive private benefit was present even if the doctors were paid reasonable amounts (negating any claim of private inurement). See generally, John D. Colombo, *Are Associations of Doctors Tax-Exempt? Analyzing Inconsistencies in the Tax-Exemption of Health Care Providers*, 9 VA. TAX REV. 469, 492-95 (1990).

¹⁹ 1976-1 C.B. 154.

²⁰ 1976-1 C.B. 151.

on the size of the charitable class, but rather the economic benefits that flowed to a for-profit entity or individuals as a result of serving the charitable class.

This theme of focusing on economic benefits to non-charitable persons or entities that resulted from a charity's operational decisions in serving the charitable class also appeared during this time in the IRS's analysis of partnership transactions between charities and private investors. At this same time, the private benefit doctrine also became prominent in IRS rulings dealing with partnership or joint-venture transactions between exempt charities and for-profit entities. Until 1979, the IRS had taken the position that the participation of an exempt entity as a general partner in a joint venture with private investors constituted a *per se* violation of the private inurement doctrine.²¹ In 1979, after the Tax Court ruled in favor of an exempt organization's participation in a partnership with private investors in *Plumstead Theatre Society, Inc.*,²² the IRS reversed course and declared in GCM 37852 that joint ventures would not necessarily result in loss of exempt status, and that a case-by-case assessment of such arrangements would be appropriate.²³ In a series of private rulings and GCM's that followed, the IRS refined its position, making clear that the primary issue involved in joint venture arrangements focused on the balance between the claimed advancement in charitable purpose from the venture and the "private benefits" conferred on individual investors. Thus in 1983 in GCM 39005, the IRS

²¹ E.g., Gen. Couns. Mem. 37259 (Sept. 19, 1977); Gen. Couns. Mem. 36293 (May 30, 1975). See generally, HILL & MANCINO, *supra* note 8, at 3-44; James J. McGovern, *Tax Exempt Organizations as Partners and Joint Venturers as Viewed by the Service*, NYU 15TH CONF. ON CHARITABLE ORGS., Chapter 3 (1987). One should note that an exempt entity's participation in a partnership as a limited partner did not raise similar problems with exempt status, presumably because the exempt organization in such an arrangement had no fiduciary duties to advance the interests of private investors and it would not incur the risk of liability of a general partner.

²² *Plumstead Theatre Society, Inc. v. Comm'r 74*, T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982). Plumstead involved a newly-formed exempt performing arts association that decided to stage a play (*The First Monday in October*, featuring Henry Fonda) at the Kennedy Center in order to raise funds for its operations. In order to fund production costs for that play, the exempt organization entered into a partnership with private investors. The IRS claimed the partnership arrangement was inconsistent with exempt status because the duty of Plumstead as general partner was to maximize profits, thus conferring an impermissible private benefit on the limited partners. The Tax Court held for the exempt organization, however, noting that staging plays was exactly the exempt purpose for which the arts organization was formed, and that none of the limited partners had any control over the operations of the arts organization or the partnership. The play, by the way, apparently was a flop (Plumstead closed the play at a loss). See James J. McGovern, *The Tax Consequences of a Charity's Participation as a General Partner in a Limited Partnership Venture*, 29 TAX NOTES 1261, 1264 (1985).

²³ Gen. Couns. Mem. 37852 (Feb. 9, 1979). See generally, HILL & MANCINO, *supra* note 8, at 3-45.

adopted a two-part analysis that first determined whether the objective of the partnership is charitable, and then closely examined the partnership arrangement “to see whether the arrangement permits the exempt organization to act exclusively in furtherance of the purposes for which exemption may be granted and not for the benefit of the limited partners.”²⁴ Four years later, in GCM 39598 (finding that a proposed rental of office building space by a subsidiary of an exempt hospital to a group of doctors was inconsistent with exempt status), the Service provided more detailed analysis of private benefit issues. Referring explicitly to the private benefit doctrine, the Service stated,

An organization is not described in section 501(c)(3) if it serves a private interest more than incidentally. . . . If, however, the private benefit is only incidental to the exempt purposes served, and not substantial, it will not result in a loss of exempt status. . . . A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals. . . . To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.²⁵

Put more succinctly, GCM 39598 established private benefit as a major factor separate from private inurement in analyzing the effect of joint ventures on exempt status. This GCM also established the two main differences between private benefit and private inurement: (1) the approach of balancing public vs. private benefit in making case-by-case determinations regarding whether a particular transaction had violated the private benefit doctrine,²⁶ as opposed to the general rule that *any* amount of private inurement resulted in

²⁴ Gen. Couns. Mem. 39005 (June 28, 1983). See McGovern, *supra* note 21, at 1265.

²⁵ Gen. Couns. Mem. 39598 (Jan. 23, 1987).

²⁶ The Memorandum appeared to adopt a sort of “but for” analysis in applying private benefit, noting in the ruling that the taxpayer in question had not sufficiently explored alternatives that could have accomplished its objective with less private benefit. In Gen. Couns. Mem. 39732 (May 19, 1988), however, the IRS rejected the proposition that a joint venture would pass muster only if the exempt entity could show it was the only way to pursue the charitable purpose at issue, thus apparently burying the “but for” analysis. See generally, HILL & MANCINO, *supra* note 8, at 3-48.

loss of exemption and (2) applying private benefit doctrine beyond “insiders” to any economic arrangement with persons or entities outside the charitable class.²⁷

B. American Campaign Academy

As of the late 1980’s, however, the IRS’s expanded definition of private benefit still awaited judicial approval, which was not long in coming. In *American Campaign Academy*,²⁸ the Tax Court analyzed the case of a school that trained individuals to be political campaign professionals. Although the school clearly served a large charitable class (e.g., it did not limit admissions to particular individuals)²⁹ and also clearly met the tests for an “educational organization” under 501(c)(3),³⁰ the Tax Court used the private benefit doctrine to hold that the organization was not exempt. Noting that most of the school’s graduates worked for the Republican Party or its related entities, the court found that the school benefited the private interests of the Republican Party to an impermissible degree and hence was not exempt, even though no evidence of traditional private inurement existed.³¹

American Campaign Academy was a watershed in the private benefit doctrine for at least two reasons. First, the court clearly sided with the IRS’s contention that private benefit constituted a separate limitation from private inurement, and was not limited to the traditional “insider siphoning” of the latter doctrine.³² Second, the court adopted the IRS’s “balancing” approach that compared “private benefits” to outsiders not a part of the charitable class with the direct benefits to the charitable class. The court opinion analyzed both “primary” and “secondary” benefits flowing from the Academy. The court accepted the fact that the primary benefit of the Academy was the education that flowed to the Academy’s students, and that, in absence of record evidence that the Academy

²⁷ See Dale, *supra* note 7, at 13.

²⁸ *American Campaign Academy v. Comm’r*, 92 T.C. 1053 (1989).

²⁹ *Id.* at 1058. The court’s opinion indicates some skepticism regarding whether the school took students who did not have Republican party affiliations, but the record did not indicate such a limitation, and the IRS conceded that the Academy did not discriminate on the basis of race, ethnicity or national origin. *Id.*

³⁰ The IRS conceded this point. *Id.* at 1063.

³¹ *Id.* at 1073-79.

³² *Id.* at 1069.

inappropriately limited admissions, the student body was a sufficiently large charitable class.³³ Nevertheless, because most of the Academy's graduates ended up working for the Republican Party, substantial "secondary" private benefit flowed to the Party and hence supported a finding that the Academy was not operated "exclusively" for charitable purposes.³⁴

C. Post-American Campaign Academy: Private Benefit Takes Center Stage

Armed with the approval of *American Campaign Academy*, the IRS quickly made private benefit a cornerstone of exemption analysis. As was the case with the development of the doctrine in the late 1970's and early 1980's, partnership/joint-venture transactions, particularly in the health care sector, became the test beds for the expanded private benefit doctrine post-*American Campaign Academy*. In November 1991, the IRS issued GCM 39862,³⁵ which used private benefit analysis to nix revenue-stream joint venture arrangements between hospitals and doctors. These arrangements, in which hospitals would "spin off" certain outpatient services to a joint venture between the hospital and doctors, were used by hospitals as a means of increasing utilization of hospital facilities by giving doctors a direct economic stake in the "spun off" facility.³⁶ The hope was that the participating doctors would refer more patients to the facility, thus increasing revenues to the hospital. In the Memorandum, the IRS ruled that these arrangements violated the private benefit doctrine, because the direct and substantial financial benefit to the participating doctors could not be justified as "incidental" to the hospital's mission of providing health services to the community.³⁷ According to the Service, "Obtaining referrals or avoiding new competition may improve the competitive position of an individual hospital, but that is not necessarily the same as benefiting its community."³⁸ The Service, however, indicated in an earlier part of the Memorandum that if a joint

³³ *Id.* at 1073-74.

³⁴ *Id.* at 1073-79. "Exclusively" really means "primarily" in this context. Treas. Reg. § 1.501(c)(3)-1(c).

³⁵ Gen. Couns. Mem. 39862, 1991 IRS GCM LEXIS 39 (Nov. 22, 1991).

³⁶ See DOUGLAS M. MANCINO, TAXATION OF HOSPITALS AND HEALTHCARE ORGANIZATIONS §19.04 (noting that net revenue stream joint ventures were used by hospitals as a means of "solidifying a referral base or deterring physicians from establishing their own competing services and facilities.")

³⁷ Gen. Couns. Mem. 39862, 1991 IRS GCM LEXIS 39 (Nov. 22, 1991).

³⁸ *Id.*

venture was needed to expand health care resources in the area, create a new provider, reduce treatment costs or provide new treatment modalities, then the arrangement might pass muster.³⁹

The private benefit analysis also played a key role in two major healthcare exemption rulings released by the IRS in the late 1990's. Revenue Ruling 97-21,⁴⁰ dealing with physician recruitment, involved two separate situations. The first concerned financial incentives to recruit a physician to be an employee of a hospital or other provider and the second related to financial incentives to recruit doctors to the community to be on staff, but not as employees of the hospital.⁴¹ While private inurement analysis controlled the first situation, the IRS relied on private benefit analysis in the second, holding that reasonable incentives would be permitted when the recruitment was justified by community need, expanding services provided by the hospital or providing new services to the community. Recruitment that simply enhanced the hospital's own bottom line (by recruiting a physician already in the community and providing services to the community at another hospital) would not be permitted under the private benefit test, presumably because such a move would not enhance services to the community.⁴²

In the second major ruling, Revenue Ruling 98-15,⁴³ the IRS examined the "whole hospital joint venture" transaction in which an existing exempt hospital corporation would contribute all its assets (the hospital building, equipment, contracts with staff and providers, etc.) to a joint venture with a for-profit hospital chain. Typically, these transactions were structured as 50-50 partnerships, and the for-profit provider would contribute cash to the deal equal to the value of the assets contributed by the exempt partner, and a for-profit management company (usually affiliated in some way with the

³⁹ *Id.* at *76 ("We recognize that there may well be legitimate purposes for joint ventures, whether analyzed under the anti-kickback statute or the tax Code. These may include raising needed capital; bringing new services or a new provider to a hospital's community; sharing the risk inherent in a new activity, or pooling diverse areas of expertise.").

⁴⁰ 1997-1 C.B. 121.

⁴¹ *Id.*

⁴² *Id.* See MANCINO, *supra* note 35, at §20.02[4][f].

⁴³ 1998-1 C.B. 718.

for-profit partner) would manage the business via a contract with the partnership.⁴⁴ Using private benefit analysis as its main analytical tool, the IRS concluded that these whole-hospital joint venture arrangements were consistent with exempt status only if the exempt partner retained control over the management of the joint venture, a position later upheld by the courts.⁴⁵ The Service noted that in cases where the exempt organization did not retain management control, it could not initiate programs to meet the health needs of its community, and other community-benefit programs such as free care for the poor, could be terminated.⁴⁶ As in GCM 39862, the IRS refused to view the economic advantages of the joint venture arrangement as a sufficient counterbalance to the private benefits flowing to the for-profit partner and the for-profit management company.

Finally, private benefit made a gratis appearance in Judge Posner's opinion in *United Cancer Council v. Commissioner*.⁴⁷ The defendant-charity United Cancer Council had entered into an agreement with a private, for-profit fundraising firm, Watson & Hughey, to conduct fundraising for UCC. Of the \$28.8 million raised, only \$2.3 million actually went to UCC – less than 10% of the gross. Although the case primarily centered on the issue whether an arm's length agreement with a for-profit fundraiser could result in private inurement (a proposition soundly rejected by the 7th Circuit), at the close of his opinion in the case, Posner suggested that private benefit doctrine could provide an alternate means of supervising “bad” agreements between exempt charities and for-profit outsiders:

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

⁴⁴ For extended discussions of this ruling, see MANCINO, *supra* note 35, at § 19.04[5][a]; THOMAS R. HYATT & BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS* 373-78 (2d ed. 2001).

⁴⁵ *E.g.*, *Redlands Surgical Services, Inc. v. Comm'r*, 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001); *St. David's Health Care System, Inc v. United States*, 349 F.3d 232 (5th Cir. 2003). The IRS control analysis in this ruling was largely approved by the courts in these cases, although the courts seemed to be more willing to consider whether the joint venture arrangement provided practical control over partnership activities, rather than strict voting control, in determining exempt status. *See, e.g.*, MANCINO, *supra* note 35, at §19.04[5][b] and [c]; HYATT AND HOPKINS, *supra* note 43, at 378-390 (discussing *Redlands*).

⁴⁶ Rev. Rul. 98-15, 1998-1 C.B. 718.

⁴⁷ 165 F.3d 1173 (7th Cir. 1999).

board's duty of care] which involved the dissipation of the charity's assets might (we need not decide whether it would – we leave that issue to the Tax Court in the first instance) support a finding that the charity was conferring a private benefit . . .⁴⁸

D. An Established Doctrine but with Cognitive Dissonance

By the turn of the new century, therefore, the private benefit doctrine appeared to be firmly entrenched as a cornerstone of IRS oversight of exempt charities. The potential application of private benefit had expanded from the common-law rule requiring a broad charitable class to a doctrine that potentially encompassed any benefit (economic or not) flowing to for-profit entities or individuals as a result of serving the charitable class. But the lack of clear doctrinal content to the private benefit concept has continued to vex the IRS, both in Revenue Rulings and private letter rulings, and in litigation settings.

The first major sign of doctrinal discord appeared in 2004, when in one of the most anticipated exemption rulings of the new millennium, private benefit analysis disappeared. Ever since the IRS issued Rev. Rul. 98-15 on whole-hospital joint ventures, both private commentators and the IRS had recognized the need for a follow-up ruling on what had become known in the trade as “ancillary” joint ventures.⁴⁹ While not legally defined, the phrase “ancillary joint venture” has come to describe a partnership between an exempt charity and a for-profit entity involving some significant, but “small,” part of the activities of the exempt charity.⁵⁰ In the hospital context, where the phrase appears to have been coined, “ancillary” joint ventures were those that involved some “spin off” of a portion of the hospital's operations, such as an outpatient surgery facility (in contrast to the “whole hospital” joint venture, where the hospital contributed all its assets and operations to the

⁴⁸ Id. at 1179.

⁴⁹ E.g., *Practitioners Hope to See Joint Ventures, Section 527 Issues in 2002 EO CPE Text*, 23 EXEMPT ORG. TAX REV. WEEKLY 47 (August 20, 2001).

⁵⁰ See Nicholas Mirkay, *Relinquish Control! Why the IRS Should Change Its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. LAW J. 21, 23 (2006); HYATT & HOPKINS, *supra* note 43 at 378 (2004 Supp.). I have put the word “small” in quotations because I am not using the word in the sense of a comparison of revenues or expenditures or other such mathematical tests. Rather, an “ancillary” joint venture is defined by the fact that the exempt participant still carries on a substantial charitable program apart from the activities of the joint venture. “Small” in this sense means a qualitative, not necessarily quantitative, judgment, though in the health care arena, “ancillary” joint ventures do tend to represent a relatively small portion of the overall revenues and services provided by the exempt participant.

partnership). In particular, the practicing bar had complained that the imposition of the “control” test of Rev. Rul. 98-15 on ancillary joint ventures was unrealistic.⁵¹ IRS officials, in turn, appeared to recognize that ancillary partnerships might need a different analysis than that provided by Rev. Rul. 98-15.⁵²

In early 2004, the IRS finally issued Rev. Rul. 2004-51 on ancillary partnerships.⁵³ Using the fact pattern of an exempt university partnering with a for-profit firm to provide distance education services (which the Service noted was an “insubstantial” part of the university’s activities), the ruling held that such partnerships would not endanger exempt status for the nonprofit participant, even if the exempt partner did not have control over the venture (in the facts, the university and for-profit partner shared control 50-50, although in the ruling the IRS noted that the exempt university retained control over curricular matters).⁵⁴ The ruling, however, contained one major surprise: a total lack of any reference in the analysis section to private benefit.⁵⁵ The concept simply does not appear in the analysis portion of the ruling at all. In fact, the entire analysis of the tax exemption issues is contained in two sentences in the ruling:

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

⁵¹ See, e.g., J. Christine Harris, *EO Repts Call IRS's Stance on Joint Ventures 'Unrealistic'*, 40 EXEMPT ORG. TAX REV. 9 (2003); Barbara Yuill, *No IRS Private Rulings on Way for Charitable Hospital Joint Ventures*, HEALTH LAW REP. (BNA) Dec. 10, 2001 at 1867. This latter article quotes T. J. Sullivan, a prominent practitioner, stating the IRS “needs to adopt a workable position on ancillary joint ventures that don’t fit” within the paradigms laid out in Rev. Rul. 98-15. See also, Mirkay, *supra* note 49, at 52-53.

⁵² E.g., Fred Stokeld, *IRS Branch Chief Clarifies Guidance on Hospital’s Joint Ventures, Charity Care*, 33 EXEMPT ORG. TAX. REV. 203 (2001) (“Friedlander also sought to allay fears that any partnership activity by nonprofit hospital systems could jeopardize exemption. Minor partnership activity will not endanger exempt status, though the activity may be taxed, he said.”)

⁵³ 2004-22 I.R.B. 974.

⁵⁴ The ruling also examined the unrelated business income tax (UBIT) implications of the arrangement, holding that under the facts of this specific case, the activities of the venture were “substantially related” to the university’s educational purpose and therefore revenues from the venture were not subject to the UBIT.

⁵⁵ The ruling did cite the “usual suspects” in the “law” section of the ruling, including Treas. Reg. §1.501(c)(3)-1(d) and the *Redlands Surgical Services* and *St. David’s* cases, but did not refer to these sources in the analysis section. 2004-22 I.R.B. at 974-75.

M's continued qualification for exemption as an organization described in § 501(c)(3).⁵⁶

The disappearance of private benefit analysis from the ancillary partnership ruling is a good indication of the problems with the doctrinal content of the concept. If private benefit is to be judged using a balancing test on a transaction-by-transaction basis (as GCM 39862 and other IRS positions set forth above tell us) and if in the partnership situation impermissible private benefit exists unless the charitable partner maintains “control” over the partnership (as the IRS claims in Rev. Rul. 98-15), then the IRS should have explained in the ruling why this transaction passed the private benefit test despite the lack of control by the exempt institution over the partnership. But the Service did not do this. Why? The answer appears simple: to have discussed and dismissed private benefit concerns, either the Service would have had to admit that the control test presented in Rev. Rul. 98-15 was too rigid or else that its transaction-by-transaction approach was incorrect (e.g., even if private benefit existed in the ancillary partnership, it should not outweigh the fact that most of the university’s activities were classically charitable educational activities aimed at a broad charitable class). Either possibility would have required the IRS to directly overrule a firmly-entrenched prior position that had won court support (see above) and doing so obviously presented some distasteful options. So instead, the IRS adopted the time-honored tradition of ignoring problems you would rather not confront, leaving the rest of us to speculate on the cosmic meaning of the ruling and what, if anything, it had to say about the private benefit doctrine.⁵⁷

⁵⁶ 2004-22 I.R.B. 975.

⁵⁷ Several high-profile practitioners expressed satisfaction with the ruling immediately after its release. See, e.g., Fred Stokeld, *Practitioners Pleased with Revenue Ruling on Ancillary Joint Ventures*, 44 EXEMPT ORG. TAX REV. 284 (2004). Later articles, however, pointed out several things the ruling left open, such as whether ownership of less than 50% by the exempt partner would result in exemption problems, or whether joint ventures that failed the “relatedness” test of the unrelated business income tax would be judged differently. For example, Michael Sanders, who was quoted in Stokeld, *supra*, as being initially favorable to the ruling, later was critical of its limitations. See J. Christine Harris, *Tax Law Professors Say Recent Joint Venture Ruling Doesn't Break Ground In Housing*, 47 EXEMPT ORG. TAX REV. 21 (2005). See Mirkay, *supra* note 49, at 58-59. My own view is that the ruling constituted a *sub-silentio* “relaxation” of the control requirement – note the stress in the ruling on the fact that the university in question controlled the parts of the venture dealing with educational policy – and was a signal that, as the court decisions in *Redlands Surgical Services* and *St. David's* seemed to indicate (note 44, *supra*), something short of voting control over a venture could still meet charitable criteria.

Although the ancillary joint venture ruling raised questions about the scope and viability of the private benefit doctrine, the IRS quickly returned to the doctrine as a major part of IRS enforcement efforts. An audit program of tax-exempt credit counseling organizations started in 2003 resulted in the revocation of exemption for a large number of the audited organizations,⁵⁸ with private benefit playing a major substantive role in the rationale for revocation. A memorandum from the IRS Office of Chief Counsel issued in 2004 advised that “we will need to argue that, even if they [credit counseling agencies] are providing education, the organizations fail the operational test: they are furthering a substantial nonexempt purpose and furthermore they are conferring impermissible private benefits.”⁵⁹ Later in this memorandum, the IRS laid out its main private benefit argument: that many or most modern credit-counseling agencies violated the private benefit doctrine because the agencies’ operations directly benefited the “back-office service providers” with whom the agencies had contractual arrangements to promote debt consolidation loans, credit repair services, buying clubs, downpayment assistance and even dietary supplements.⁶⁰

Following hot on the heels of the credit counseling analysis, the IRS published Rev. Rul. 2006-27, in which it analyzed exemption for organizations that provided cash downpayment assistance grants to poor individuals to help purchase housing.⁶¹ Situation 2 of this ruling involved an organization that provided this assistance largely via payments from the home seller (that is, the seller would make a “donation” to the organization, which in turn would transfer this amount, less fees, to the buyer as downpayment assistance). In this situation, the IRS concluded that the circular cash flow (from seller to organization to buyer then back to seller) constituted an impermissible private benefit to the sellers and

⁵⁸ See Fred Stokeld, *Everson Announces Credit Counseling Enforcement Initiative*, 52 EXEMPT ORG. TAX REV. 250 (2006). The difficulties with credit counseling agencies led Congress to enact new Section 501(q) to specially regulate tax exemptions for these organizations.

⁵⁹ Office of Chief Counsel Memorandum 200431023 at 9 (July 30, 2004) *available at* <http://www.irs.gov/pub/irs-wd/0431023.pdf> (last viewed 6/16/2006).

⁶⁰ *Id.* at 21-22. Credit counseling agencies are now subject to special rules in I.R.C. Section 501(q), which specifically regulates the potential interaction between an exempt CCA and “back office” providers. See, e.g., I.R.C. Section 501(q)(1)(F) (prohibiting referral fees).

⁶¹ 2006-21 I.R.B. 915.

real estate brokers involved in the transactions, despite the fact the organization “also serves an exempt purpose.”⁶²

The most recent “official” activity with respect to private benefit was the IRS’s adoption of a new regulation, 1.501(c)(3)-1(d)(2)(iii) that provides three examples of private benefit. As explained below, these examples really have no unifying theme, with example 1 being a classic “size of the charitable class” problem, while examples 2 and 3 deal with exclusive economic arrangements between the purported charity a for-profit interests.

E. Private Benefit as a Study in Doctrinal Confusion (or Doctrinal Absence)

The history recounted above illustrates a doctrine in disarray. From its beginnings as a restatement of the requirement of a broad charitable class, private benefit has morphed into a phrase used as cover to deny tax exemption in a variety of circumstances that have no doctrinal links. Private benefit may refer to inadequate size of a charitable class; it might involve direct financial benefits (e.g., hospital partnership with doctors; the back-office deals with credit counseling agencies; the circular cash in down-payment assistance) or indirect non-financial benefits (the trained workforce in American Campaign Academy); it may involve insiders or outsiders; individuals or corporations. We seem to know that we have to balance benefits to non-charitable parties against the benefits provided to charitable parties in individual transactions, but we have no parameters regarding how that balance should take place. Judge Posner seemed to equate it with a failure of the common law duty of care imposed on a charitable board. After using it as a bludgeon against joint venture transactions, the IRS ignored it in one of the most significant joint venture rulings issued by the agency, likely because explaining it away was an inconvenient truth. In short, the private benefit doctrine seems to be pretty much where the first-amendment doctrines relating to pornography were when Justice Potter

⁶² Id. at ___ [Lexis *18].

Stewart wrote his famous analysis, “I know it when I see it.”⁶³ The difference is that the IRS seems to see it (private benefit, that is; not pornography) everywhere.⁶⁴

This lack of doctrinal content is easily spotted in any sampling of case law or private rulings. A keyword search of “private benefit” in the Westlaw PLR database beginning in January 2010 and ending in May 2011 revealed 82 private rulings that recited the phrase. Of these 82, twenty-five made some reference to private benefit in the “applicable law” section of the ruling, but then failed to apply it as part of the analysis of the facts. In the remaining 57 rulings, the use of the private benefit concept varied widely. In one group of cases, “private benefit” was invoked alongside a simple (and deserved) conclusion that the organization in question had no charitable purpose. For example, in PLR 201047033, an individual created a tax-exempt organization ostensibly to provide computers to low-income individuals, but instead deposited checks from his own personal customers into the exempt organization’s account, and then wrote expense checks out of the organization’s accounts to avoid paying taxes on personal income. Though the ruling used the phrase “private benefit” to describe the situation, it is clear from the ruling that the organization actually had no charitable purpose at all, and was merely a tax shelter for its founder.

A second group of cases, however, return to the common-law roots of private benefit, and invoke the concept to deny exemption when the organization lacks a sufficient charitable class. In PLR 201039043, for example, the organization provided scholarships to the founders’ own children. In several other rulings involving membership organizations, the IRS used the private benefit doctrine to deny exemption on the grounds that the membership was too small to constitute a charitable class. PLR 201014068 is the best-reasoned of this group, involving an organization that provided educational programs for occupants of a mobile home park. The ruling concluded that the group of occupants

⁶³ *Jacobellis v. Ohio*, 378 U.S. 184 (1964).

⁶⁴ Most people who remember Justice Stewart’s famous quote forget the context – or indeed, the rest of the sentence he wrote, which was “But I know it when I see it, and the motion picture involved in this case is not that.” I fear the IRS sees every innovative deal between an exempt charity and some third party outside the charitable class as an issue of private benefit. We should remember the “this case is not that” part of Justice Stewart’s famous phrase.

was not a large enough “community” to constitute a charitable class, and hence involved excessive private benefit.

The amorphous nature of this “charitable class” use of private benefit also has surfaced repeatedly in IRS litigation dealing with HMO’s. In its second opinion in *Geisinger Health Plan*, for example, the Third Circuit denied exemption to Geisinger using private-benefit-like language when it stated “the community benefited is, in fact, limited to those who belong to GHP . . . this self-imposed precondition suggests that GHP is primarily benefiting itself (and, perhaps, secondarily benefiting the community) by promoting subscribership throughout the area it serves.”⁶⁵ What this analysis misses is that the charitable class served by the Geisinger HMO in fact consisted of the HMO subscribers, and the Tax Court previously had found that the size of this class was nearly unlimited – that is, the subscriber group constituted a large enough class to be a charitable class.⁶⁶ In other words, the Third Circuit’s second *Geisinger* opinion mixed analysis of the charitable class with a charitable purpose analysis (and arguably got neither correct).

In a third group of rulings, private benefit is invoked alongside private inurement to deny exemption to organizations clearly involving transactions that siphon economic value to insiders. In other words, these are (or should be) analyzed solely as private inurement cases, but instead become a mish-mash of private inurement and private benefit analysis. PLR 201047033, discussed above, could be placed in this category, but there are others, such as PLR 201039034, where the organization in question operated an airport with money loaned from the founder’s business at a higher-than-market interest rate (thereby siphoning money from the exempt organization to the founder’s business). In its analysis, the IRS stated, “we have often observed that the prohibition against private inurement of net earnings appears redundant, since the inurement of earnings to an interested person or insider would constitute the conferral of a benefit inconsistent with operating exclusively

⁶⁵ *Geisinger Health Plan v. Comm’r*, 985 F.2d 1210, 1219 (3d Cir. 1993).

⁶⁶ *Geisinger Health Plan v. Comm’r*, T.C. Memo 1991-649 (1991). Interestingly, this Tax Court Memorandum opinion got the private benefit analysis with respect to charitable class exactly correct: the class in GHP was “practically unlimited.” Accordingly, there was no private benefit in the classic “size of charitable class” meaning. The Third Circuit, to be blunt, simply blew it.

for an exempt purpose” and “the private inurement prohibition may arguably be subsumed within the private benefit analysis of the operational test.” In other words, private inurement is a subset of private benefit which in turn is simply a way of expressing the charitable purpose requirement. Well, no. Or maybe. Or, who knows?

Another recent stark example of this kind of fuzzy thinking at the judicial level is *Rameses School v. Commissioner*,⁶⁷ where the charity (Rameses School) wrote checks out of its own account for personal expenses of the founder, a classic case of private inurement. Instead of analyzing the case as an open-and-shut case of private inurement gone wild, however, the Tax Court invoked the private benefit doctrine and analyzed the case virtually exclusively as a private benefit case, even noting that “a substantial body of caselaw has explored the concept of private benefit within the framework of the relationship between an organization claiming tax-exempt status and its founder (or small group of related insiders)”⁶⁸ followed by a string of cites to what were clearly private inurement cases. In short, the IRS isn’t the only government entity that doesn’t understand private benefit; the courts are hopelessly lost, too (even the Tax Court, which is particularly scary).

III. What Do We Want Private Benefit To Be?

Part I of this paper illustrates that pinpointing the doctrinal content of the private benefit doctrine is difficult, at best. This then leads to the question of what we would like the doctrinal content of private benefit to be. I suggest that there are four possibilities. First, we could return private benefit to its common-law antecedent as a description of a lack of charitable class. Second, we could view private benefit as another way of describing an organization that in fact does have a charitable class, but whose operations have become more concerned with serving/supporting non-charitable entities than with pursuing charitable activities. In this formulation, private benefit is just another way of

⁶⁷ T.C. Memo 2007-85. My thanks to Evelyn Brody for this insight.

⁶⁸ *Id.* at 14.

saying that an organization no longer has a *primary* charitable purpose. Third, we could adopt Judge Posner’s suggestion in the United Cancer Council case that private benefit tracks a failure of the common-law duty of care for nonprofit boards – in other words, private benefit would be the federal law “incorporation” of a failure of the duty of care under state law (much like the private inurement limitation of 501(c)(3) mirrors the “nondistribution constraint” of state nonprofit organization law). Fourth, we could develop new doctrinal content for private benefit, which I explore further below.

The discussion below largely focuses on options two through four. Returning private benefit to its classic “no charitable class” definition would be easy enough (and in fact is what Example 1 of the newly-added Regulations Section 1.501(c)(3)-1(d)(1)(iii) covers), but before we do that we should explore whether there are sound reasons to adopt a different approach.

A. A Substitute for the Primary Purpose Test?

One possibility for an expanded definition of private benefit relates to the primary purpose requirement. This possibility is that the “evil” identified by an expanded view of private benefit is that a charity has become more concerned with serving private interests than in delivering charitable services – in essence, under this view, private benefit is simply a specialized way of saying that a charity no longer is *primarily* pursuing a charitable purpose, but instead has become a “for-profit in disguise.”⁶⁹ The difference between this view and the historical definition of private benefit is that under this view, an organization might still be serving a large-enough charitable class, but that doing so has become “secondary” to benefiting entities or individuals outside the charitable class. Think, for example, about a nominally nonprofit hospital whose board is controlled by a small group of doctors who have the only admitting privileges to the hospital. In this case, one might argue that the hospital is still providing health care for a broad enough charitable class, but the overriding purpose of the hospital is to benefit the controlling doctors by providing

⁶⁹ Burton A. Weisbrod, *The Nonprofit Mission and Its Financing*, in TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR 11 (Burton A. Weisbrod, ed. 1998).

them with a closed, preferential system to practice medicine – that is, in this case, serving the charitable class has become secondary to serving the private interests of the doctors.⁷⁰

There is certainly language in IRS rulings and court cases that would suggest this is the proper interpretation of private benefit. For example, in the key rulings set forth above in which the IRS has applied private benefit analysis, it routinely cites the operational test for exemption;⁷¹ even the court in *American Campaign Academy* concluded that the excess of private benefit meant that the organization was no longer primarily operated for charitable purposes.⁷²

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

The actual scope of the private benefit doctrine as implemented, moreover, indicates that the IRS really does not see private benefit as simply a substitute for the primary purpose rule. If we are to believe the IRS's transactional approach, then private benefit (like private inurement) can cause a loss of exemption because a single transaction involves private benefit, even when the overall operations of a particular organization are more charitable than not (e.g., "primarily" charitable). I would suggest that there is little

⁷⁰ This example is essentially Hospital B from Rev. Rul. 69-545, 1969-2 C.B. 117.

⁷¹ See, e.g., Rev. Rul. 2006-27, 2006-21 I.R.B. 915 (citing the operational test of Treas. Reg. §1.501(c)(3)-1(c)(1)); 98-15, 1998-1 C.B. 718 (same); Rev. Rul. 97-21, 1997-1 C.B. 121 (same).

⁷² *American Campaign Academy*, 92 T.C. 1053, 1079 (1989).

doubt that the hospitals engaged in the revenue-stream joint ventures described in GCM 39862 above were still primarily centered on a mission of providing health services to the general population, a purpose that the IRS recognized as charitable in Rev. Rul. 69-545.⁷³ Moreover, in its private benefit rulings, the IRS likes to stress the quotation from the old *Better Business Bureau* case that “the presence of a single . . . [non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly . . . [exempt] purposes.”⁷⁴ This quote supports the conclusion that private benefit, like private inurement, is a problem even when charitable purposes might globally outweigh a private benefit transaction. Despite the final conclusion of the court in *American Campaign Academy* cited above, moreover, the crux of the opinion was that the organization in question failed exemption because of *secondary* benefits, not because it failed to provide *primary* charitable services to a charitable class.⁷⁵ So it seems that, despite the citations to the primary purpose rule in various rulings, the IRS does not *really* treat private benefit as simply shorthand for the primary purpose test, but rather as a separate limitation on an organization that arguably in fact has a primary charitable purpose.

In any event, if private benefit is to be useful as a separate concept, it must be more than just a shorter way of saying that the charity no longer has a primary charitable purpose. If that is all private benefit means, it is just as simple for the IRS to state that “the organization in question fails the primary purpose test” as to say that “the organization in question suffers from excessive private benefit.”

B. The Posner Approach: Private Benefit as a Federal Incorporation of Duty of Care

A different approach to specifying the content of the private benefit doctrine would focus on Posner’s suggestion that the transaction in United Cancer Council might have

⁷³ 1969-2 C.B. 117.

⁷⁴ *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 283 (1945). *See, e.g.*, Rev. Rul 98-15, 1998-1 C.B. 718 (citing this language).

⁷⁵ *See* text at notes 27-33, *supra*.

violated the private benefit doctrine. To repeat the most relevant part of that opinion, “[A] violation of [a governing board’s duty of care] which involved the dissipation of the charity’s assets might (we need not decide whether it would – we leave that issue to the Tax Court in the first instance) support a finding that the charity was conferring a private benefit . . .”⁷⁶

Note that Posner’s formulation of private benefit focuses on economic outflow from the charity – “the dissipation of the charity’s assets” – and not amorphous “secondary” benefits such as the benefit of a trained workforce enjoyed by the Republican party, that by definition does not involve any economic outflow. But as noted above, the private inurement limitation and Section 4958 already cover the situation in which a charity diverts assets for less than fair market value to “insiders” not a part of the charitable class.⁷⁷ One immediate question that arises, therefore, is whether one can conceive of such diversion transactions that do not involve insiders or whether there might be situations in which even transactions that occur at fair market value are nevertheless troublesome. If so, perhaps we need the private benefit doctrine to address these situations. This area holds more promise in identifying a separate private benefit doctrine, particularly since most of the cases in which private benefit is invoked involve economic benefits from contractual relationships with for-profits (joint ventures, service contracts and the like) and because it offers some potential for actually defining a separate private benefit concept that is not already covered by other exemption rules.

On the one hand, one is hard-pressed to conceive of a situation in which a charity *intentionally* diverts assets at less than market value to an outsider. If a charity enters into an economic transaction with someone who has no influence over the charity, there simply is no reason to believe that the charity would intentionally hand assets over to that person for less than full value. In fact, this principle of arms’ length transactions being presumed to be fair-market-value exchanges is a core principle of all of tax law,⁷⁸ born from general

⁷⁶ 165 F.3d 1173, 1179 (7th Cir. 1999).

⁷⁷ See text at notes 7-8, *supra*.

⁷⁸ The classic definition of “fair market value” for tax purposes is the price at which a willing buyer and willing seller, each in possession of the relevant facts, agree on. Treas. Reg. § 1.170A-1(c)(2); 20.2031-1(b)

observations of human behavior and the administrative impossibility of policing every exchange transaction. No one wants to be a “chump” taken advantage of by the other side. Ergo, no one is going to knowingly part with one’s assets for insufficient value unless there is some relationship between the parties that signals the transaction is not at arm’s length. Accordingly, the notion that one would intentionally overpay or undercharge for services outside a context in which the recipient of the economic benefit has some kind of insider connection does not comport with either basic assumptions of our tax system nor with normal human economic behavior.

What is possible, however, is that the managers of a charity *negligently* “divert” assets to for-profit interests even in arm’s length transactions. This is the possibility recognized by Judge Posner at the end of his opinion in the *United Cancer Council* case when he opined that irresponsible management could result in private benefit.⁷⁹ That is, because of a lack of information or a lack of rigor in analyzing the benefits and costs of particular transactions, charities may engage in transactions with outsiders that either are economically inefficient or result in them paying too much or getting too little for what they give up – what I will call a “failure to conserve” assets for the benefit of the charitable class. Such a failure to conserve is bothersome, because the charity is wasting assets that should otherwise be used for charitable services – in effect, the charity is shifting some of the economic value from the various tax benefits we confer on exempt organizations (exemption, charitable contributions deduction, etc.) away from charitable services.⁸⁰

and § 25.2512-1(b). *See, e.g., Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184, 189 (Ct. Claims 1954) (fair market value of property received in exchange can be proven by reference to fair market value of property given up, since in an arm’s length exchange the two values “are either equal in fact or are presumed to be equal.”).

⁷⁹ *See* text at notes 46-47, *supra*.

⁸⁰ Of course, from purely the perspective of tax revenues, there is no “leakage” in the tax system when a charity overpays or undercharges a for-profit entity. Doing so actually *increases* the tax collections from the for-profit. But “tax-leakage” obviously is not the only policy concern of the IRS or Congress in administering charitable tax exemption; if it were, there would be no private inurement doctrine – indeed, if tax collections were all that motivated enforcement efforts, we would welcome private inurement, because the more assets the charity transfers from the exempt sector to the for-profit sector, the greater tax collections would be. The private inurement doctrine indicates that “charitable asset leakage” is at least as important a policy consideration in this area as “tax leakage” (though one might well question whether the

While Posner’s approach holds promise in identifying an area for which there is no existing clear doctrinal limit in tax law, his suggestion that the tax law concept of private benefit should be tied to violations of the common-law duty of care is troublesome. Because the duty of care is essentially a state law question, tying a federal tax concept of private benefit to this body of state law potentially presents issues of consistency across jurisdictions: what might be a failure of the duty of care in Massachusetts might not be in Arizona. Because federal tax law is applicable to organizations across all state jurisdictions, a single federal standard of behavior is more appropriate. Moreover, as I note below, one might wish to demand more directors than would be required by the “ordinarily prudent person” standard of existing state law.⁸¹ Accordingly, adopting Posner’s suggestion that “private benefit” should be tied to the duty of care standards for directors is not completely appealing.

C. A New Federal Standard for Private Benefit: Failure to Conserve Charitable Assets

1. Overview

Developing a new federal standard for private benefit could start with Posner’s connection between private benefit and “the dissipation of charitable assets,” or what I call a “failure to conserve” charitable assets for charitable beneficiaries. I believe this failure to conserve is most likely to arise in two separate circumstances outlined below, neither of which is specifically addressed by either the primary purpose rule or the private inurement/4958 regime. Suppose, for example, that we imagine a nonprofit hospital that has a community board and an open staff policy, treats Medicare patients and provides

IRS, whose job it is to collect taxes, ought to be the party in charge of enforcing these non-tax considerations).

⁸¹ The duty of care, of course, covers all sorts of board-level decisions, and the state law surrounding the standards for the duty of care is still somewhat in flux. Marion Fremont-Smith reports that as of the beginning of 2003, 43 states had codified a standard for the duty of care, over half of which had adopted the definitions in the ABA’s Revised Model Nonprofit Corporation Act (“RMNCA”) promulgated in 1987. Marion Fremont-Smith, *GOVERNING NONPROFIT ORGANIZATIONS* 207 (2004). The American Law Institute also is currently engaged in a project on nonprofit law that may further refine the duty of care at the state level. See AMERICAN LAW INSTITUTE, *PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS*, [UPDATE CITE]

free emergency treatment to the poor. These are the requirements for charitable exemption for a hospital set forth by the IRS in Rev. Rul. 69-545. But it so happens that this particular hospital conducts all its services via contract with for-profit entities. The emergency room is managed by Emergency Doctors, Inc.; patient records and billing are farmed out to Hospital Records Corporation; nursing services are provided by Nurses Clinic, Inc.; diagnostic and lab services are likewise in the hands of for-profit providers, and so forth.⁸² All the contracts with these providers are negotiated at arm's length at fair market value, but of course the negotiated price includes a profit margin for each for-profit entity providing services to the hospital and its patients.

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

Similarly, one might imagine situations in which an exempt charity negligently fails to fully exploit the value of rights it has assigned to an unrelated for-profit entity. Suppose, for example, that an exempt nonprofit tissue bank enters into a long-term

⁸² My hypothetical may not be far from the truth, at least if one believes the report of the Champaign County Board of Review recommending that the Illinois Department of Revenue revoke tax exemption for Carle Hospital in Urbana, IL. In this report, the Board of Review recommended that the Illinois Department of Revenue revoke property tax exemption from Carle Hospital based in part on its extensive contracts with for-profit groups to provide services to hospital patients. CHAMPAIGN COUNTY BOARD OF REVIEW, NOTES ON EXEMPT APPLICATIONS 10-11, available at <http://www.co.champaign.il.us/BOR/CARLE2004.pdf> (last visited February 21, 2006).

exclusive agreement to provide tissue to a single unrelated for-profit tissue processor.⁸³ The arrangement is at arm's length and therefore under general tax law presumptions, we would normally assume that it is at "fair market value." But the tissue bank has given up the right to exploit changes in the market by engaging in a long-term exclusivity agreement. It is possible in this case that the nonprofit is conferring a competitive advantage on the for-profit processor (in the form of a stable supply of tissue at a fixed price) and in the process failed to extract an above-market price (supra-normal profit) for the tissue justified by this competitive advantage. This situation, therefore, might also present a case in which the charity has failed to conserve charitable assets by giving up a valuable right (the right to freely exploit the future market for its goods) without full compensation. One might even imagine cases in which, because of such long-term "cozy" relationships, the nonprofit involved fails to engage in the hard bargaining with its long-term business associate that would result in the proper capture of these supra-normal profits.

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

⁸³ This example was inspired by the analysis in Robert A. Katz, *The Re-Gift Of Life: Can Charity Law Prevent For-Profit Firms From Exploiting Donated Tissue And Nonprofit Tissue Banks?* 55 DePaul L. Rev. 1201, 1261-65 (2006). Professor Katz suggests that under current law, the private benefit doctrine could be read to capture transactions in which directors of a nonprofit exempt tissue bank transfer tissue to a for-profit processor, because under the National Organ Transplant Act the exempt tissue bank is not permitted to capture the full value of the tissue transferred to a for-profit processor. *Id.* Ergo, the exempt tissue bank is benefiting the private interests of the for-profit processors, and arguably are doing so in a substantial way. Under my formulation, presumably this would no longer be a risk, since the directors of the charity would not be negligently failing to capture economic value, but rather simply following the law. See *id.* at 1264 (under Posner's formulation, no private benefit would occur as a result of following NOTA). See also, Robert A. Katz, *A Pig in a Python: How the Charitable Response to September 11 Overwhelmed the Law of Disaster Relief*, 36 IND. L. REV. 251, 264 (2003) (noting that under Posner's formulation of private benefit in the *United Cancer Council* case, private benefit occurs in a case in which the directors violate their duty of care and negligently waste nonprofit assets).

situations involve cases in which arguably a charity may not be appropriately conserving charitable assets for its charitable class.

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

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

But when it comes to what I will call "core services" of the exempt organization (e.g., services that form the core primary charitable purpose, such as a hospital providing medical services to its patients, as opposed to buying electrical power to heat its building, or a tissue bank supplying tissue to a for-profit processor for the ultimate purpose of

bettering the health of the community), the above presumption no longer seems reasonable. If the major purpose of a hospital is to provide health services to patients, we would expect the hospital itself to be as efficient in delivering those services as an outside provider. It is the hospital, after all, not the outside provider, that has the invested capital base and presumably some expertise in providing health services. Similarly, if a tissue bank enters into an exclusive contract to supply tissue to a single processor, we might logically ask why (if it were legal to do so⁸⁴) the tissue bank is not “shopping the market” for its product in order to maximize revenue. Since the tissue bank is intimately involved in the tissue market, we would expect them to have the relevant information necessary to fully exploit their “product” and use this information to their advantage. Thus unlike the case with contracts for routine services, at least we should not *presume* that hiring a for-profit company to provide services to the hospital’s patients or entering into an exclusive arrangement with a for-profit tissue provider is more efficient or “better” in some way than hiring nurses directly or dealing with several processors (or non-profit processors). In fact, perhaps an opposite presumption is justified in these cases: that is, if core services are “outsourced” to for-profit enterprises or exclusive deals involving core services are entered into that may confer competitive advantages on a for-profit entity, we might presume that a charity is failing to conserve charitable assets.

This counter-presumption, however, raises the second overbreadth possibility. Certainly we could imagine situations in which for one reason or another the charity is justified in outsourcing core services or is justified in conferring an economic advantage on a for-profit as part of a business relationship. For example, perhaps the governing board of my hypothetical hospital made a detailed study of the costs of providing services directly versus outsourcing them, and concluded that outsourcing would actually save money while keeping quality constant. Or my hypothetical tissue bank might have done a study of the tissue market and reasonably believed that the price negotiated for its exclusive arrangement was preferable to the risk of a downward price movement in the tissue market over the term of the exclusive agreement. If the board of either of my

⁸⁴ Current law in the form of the National Organ Transplant Act limits the ability of tissue banks to capture these revenues. See Katz, *The ReGift of Life*, *supra* note 82, at 1210-12.

hypothetical charities made such a considered judgment, then presumably there is no failure to conserve charitable assets (or at least tax-exemption law should not second-guess such a considered judgment under the circumstances).

2. *The Resulting “Failure to Conserve” Test*

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

This “failure to conserve” analysis could in theory apply to any transaction in which a charity contracts for service with a for-profit entity (since all such transactions involve the payment of a profit margin to the for-profit), but common sense tells us that in routine transactions for “incidental” services, such contracts are in fact justified on efficiency grounds. As a matter of administration of the tax laws, then, we should not apply private benefit analysis to such transactions. Instead, private benefit analysis should come into play primarily in transactions between a charity and a for-profit entity that involve core services – that is, situations in which an exempt entity outsources the delivery of core services to its charitable class or situations in which the exempt entity enters into an economic arrangement with a for-profit involving core services that arguably grants a competitive advantage to the for-profit. In these cases, where we legitimately can be suspicious of the economic efficiency of outsourcing such services or entering into competitive advantage arrangements, the concept of “failing to conserve” charitable assets is most in play.

Of course, the charity should be given the chance to rebut this suspicion by showing that the economic arrangements with outsiders for these core services are in fact a more efficient or “better” way to deliver services to the charitable class. Accordingly, if

the charity can make a convincing case that it fully considered the options and reached a reasonable conclusion that its contractual arrangements were a better way to serve its charitable purpose, then the arrangements should be permitted to stand. In other words, in circumstances where we might legitimately view a particular economic transaction with suspicion, the charity should be required to provide a reasonable justification for why the transaction is in the best interests of serving the charitable class.

The next question, then, is what behavior should be sufficient to meet this “reasonable justification” standard. In general terms, one could envision using the same sort of approach used in the salary safe-harbor provision of the Regulations under Section 4958, requiring a board to use comparable salary data and to document the basis for its decision.⁸⁵ Applying this approach to the failure to conserve test, the “reasonable justification” would need to be based upon relevant comparable data and practices by similar exempt charities, and the organization would have to document a rationale for why it believed the transaction “improved” services to the charitable class. In my hospital hypothetical, for example, the relevant data likely would consist of a comparison of the costs and quality of providing services internally versus outsourcing such services. My hypothetical tissue bank might document the volatility in the tissue market that would justify a long-term arrangement at a stable price, or show that the price in the long-term deal was higher than that provided by the “spot market” over some average period to illustrate that the exempt organization had fully considered the value of the economic advantage it was granting to the for-profit processor.

⁸⁵ Treas. Reg. § 53.4958-6(a). There has been some suggestion that this safe-harbor may be too lenient. In 2005, for example, the Joint Committee on Taxation proposed deleting the safe harbor and substituting a “due diligence” standard that would keep the burden of proof on the charity to explain how it approved a salary in certain circumstances. Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05, Jan. 27, 2005, at 254-269. I would not apply the burden-shifting provision of Reg. § 53.4958 to my analysis, however, because I view the kinds of paradigm transactions I have identified (“outsourcing” core services or using core services as the basis for conferring a competitive advantage on a for-profit) as inherently suspect. Ergo, the charity should retain the burden of proving that these transactions are in the best interests of the charitable class.

D. Matching the “Failure to Conserve” Rationale to Existing Doctrine

Now that I have outlined the failure to conserve rationale, the paradigm situations in which it might occur, and the resulting doctrinal test for private benefit in these circumstances, the next logical question to ask about the proposal is how it would affect existing precedent on the application of the private benefit doctrine, and how it might apply to various “troublesome” scenarios in which the IRS has used private benefit as a policing tool.

1. HMO’s and “*Serving the Private Interests of Members*”

Almost from the time Rev. Rul. 69-545 was promulgated, the IRS has resisted exemption for health maintenance organizations. As noted above, the IRS has used the argument that HMO’s are operated for the private benefit of their members to advance (successfully) their position. I have previously criticized the IRS’s position that “contract” HMO’s are somehow less entitled to tax exemption than the HMO in *Sound Health* (which provided health benefits directly to members), but under the “failure to conserve” rationale set forth above, there may be some reason to engage contract HMO’s on the private benefit front. Contract HMO’s, it seems, provide a paradigm example of a charitable organization contracting out core services (health care), in many cases to for-profit service providers. Of course, it may well be that the simple answer to this is efficiency: that HMO’s actually conserve charitable resources by providing more efficient health care delivery, and such a conclusion would be sufficient to overcome any presumption of a private benefit problem. Since HMO’s were largely created on efficiency grounds, I tend to believe this explanation is true, and that therefore even contract HMO’s do not have a private benefit problem in the “failure to conserve” sense proposed above.⁸⁶

⁸⁶ Note, however, that certain HMO’s might well have too small a charitable class and therefore fail under the common-law definition of private benefit. See, e.g., *IHC Health Plans, Inc. v. Comm’r*, 325 F.3d 1188 (10th Cir. 2003) (concluding that two of the HMO’s in question did not serve a large enough class to be charitable). As I note below, however, I am not a fan of having a single phrase (e.g., “private benefit”) apply to two very distinct and different analytical paradigms, which I think results in confusion and unnecessary

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

The use of private benefit as a tool to police transactions involving core services necessarily requires me to revise my past position that joint venture transactions should be subjected *only* to primary purpose/commerciality/unrelated business income analysis.⁸⁷ That analytical paradigm should still be the first step in analyzing joint venture transactions, but if the exempt venturer survives this initial stage and the venture involves core services, I would bring the “failure to conserve” analysis into play as a second analytical step. As indicated below, as a practical matter, my analysis would reach the same end results as the IRS has reached in its recent rulings (though perhaps not the same result as in some older rulings), and would also provide a coherent analysis for private benefit that would be applicable across all joint ventures, ancillary or not.

Let’s start with the whole hospital joint venture as set forth in Rev. Rul. 98-15. I still would begin the analysis of these transactions with the primary purpose/commerciality doctrine which would ask whether the exempt venturer is still engaged “primarily” in a charitable activity.⁸⁸ In the case of a whole hospital joint venture, this question is usually answered by asking whether the joint venture itself is a charitable activity.⁸⁹ Since the exempt venturer in these cases generally has no continuing charitable program other than being a partner in the hospital venture, if the joint venture itself is not charitable, the analysis is over, because the exempt entity is primarily engaged in a commercial activity, not a charitable one.⁹⁰ Thus in these cases, “private benefit” never becomes an issue at all.

fuzzy thinking. If we want private benefit to mean something other than the classic common-law definition of a too-small charitable class, then let’s find a different way to describe the “too-small a class” situation. Like, maybe, “Your organization does not serve a large enough group to constitute a charitable class, and therefore does not meet the common-law definition of charity.” That isn’t so hard, is it?

⁸⁷ John D. Colombo, *A Framework for Analyzing Exemption and UBIT Effects of Joint Ventures*, 34 EXEMPT ORG. TAX REV. 187 (2001). See Mirkay, *supra* note 49, at 60-65. If the IRS will adopt the approach in this article to private benefit doctrine, I promise to walk down Pennsylvania Avenue in sackcloth and ashes as a sign of my repentance.

⁸⁸ Colombo, *supra* note 86, at 189.

⁸⁹ *Id.* at 190.

⁹⁰ The venturer is deemed to be engaged in the underlying activity of the joint venture. Rev. Rul. 98-15, 1998-1 C.B. 718, 720-21. Hence if the venture itself is not a charitable activity, the venturer should be viewed as simply conducting a for-profit business. If the venturer has no other substantial charitable activity, it fails the primary purpose test. Colombo, *supra* note 86, at 190.

This approach is radically different analytically from the fixation on control and private benefit that pervades Rev. Rul. 98-15, although ultimately the result would be the same (no exemption for the nonprofit venturer).⁹¹

Suppose, however, that we move to the case of an exempt organization whose charitable purpose is to provide low-income housing, and does so by being the general partner of limited partnerships with for-profit investors who essentially receive nothing in return except an allocation of the low-income housing tax credit provided by Section 42 of the Code. For some period of time, the IRS appeared singularly schizophrenic about permitting nonprofit organizations to engage in low-income housing partnerships, at once recognizing the charitable purpose of such arrangements and at the same time invoking private benefit analysis (and the control test) as a limitation on such arrangements that essentially prohibit exempt partners from structuring the partnership in ways demanded by the market.⁹² While the IRS since has taken some steps to treat their schizophrenia,⁹³ the low-income housing joint-venture area is another example of how the lack of clear doctrinal content in the private benefit doctrine has led to untoward policy results, and also is a good example of how the proposed “failure to conserve” rational would potentially cure these doctrinal difficulties.

Under my analysis, one still begins with the primary purpose issue. In this case, however, one might conclude that the venture itself (providing low-income housing) is a

⁹¹ As I have observed in the past, the IRS’s fixation on control in these cases is misplaced; control should be a factor in determining whether the joint venture itself is charitable, but the role of control ends there. Once we have determined whether the joint venture is charitable, the analysis shifts to a “primary purpose”/UBIT analysis. Colombo, *supra* note 86, at 191.

⁹² See, e.g., Jerry O. Allen and Alan D. Duffy, *Solving the Low-Income Tax Credit Housing Partnership Dilemma*, 49 EXEMPT ORG. TAX REV. 319 (2005); J. Christine Harris, *Tax-Exemption And Low-Income Housing Ventures: Irreconcilable Differences?* 47 EXEMPT ORG. TAX REV. 329 (2005); J. Christine Harris, *Tax Law Professors Say Recent Joint Venture Ruling Doesn't Break Ground In Housing*, 47 EXEMPT ORG. TAX REV. 21 (2005); Michael I. Sanders and Celia A. Roady, *EO Practitioners Suggest Way To Expedite Exemptions For Low-Income Housing Orgs.*, 37 EXEMPT ORG. TAX REV. 127 (2002).

⁹³ In late April, 2006, the IRS released additional guidance for charitable organizations engaging in low-income housing partnerships that sought to ameliorate some of these criticisms and seems to support the argument in the text below that such partnerships are usually the best, if not only, vehicle for pursuing the financing necessary to bring low-income housing project to fruition. See, e.g., Michael I. Sanders and Jerome A Breed, *IRS Issues Guidance for Nonprofit Organizations Involved in Low-Income Housing*, 52 EXEMPT ORG. TAX REV. 263 (2006); Internal Revenue Service, *Memorandum for Manager, EO Determinations*, April 25, 2006, available at <http://www.irs.gov/pub/irs-tege/urbanmemo42406.pdf> (last viewed 6/20/2006).

charitable activity by virtue of the fact that the venture is itself engaged in relief of the poor.⁹⁴ But even if that is true, because the nonprofit organization has entered into a contract (the partnership agreement) with for-profit entities (the investors in the partnership) to provide core services (create low-income housing), we would invoke the private benefit analysis and ask the nonprofit to provide reasonable justification for its transaction. This should not be hard to do; if the transaction is properly structured as an arm's length deal with the investors, the "reasonable justification" will most likely be that the partnership is the most economically efficient vehicle for the nonprofit to execute its charitable purpose, since other financing will either be unavailable or more expensive because of the risk inherent in low-income housing.⁹⁵ In other words, there is no way for the exempt organization to better conserve charitable assets than by using the partnership financing vehicle to accomplish its exempt purpose. On the other hand, if the exempt venturer "gives away the store" in the partnership agreement by, for example, bearing a disproportionate amount of the economic risk in the venture, then one might legitimately invoke the private benefit limitation for this failure to conserve charitable assets.

When it comes to ancillary joint ventures, things would get modestly more complicated than they may be today. If, in fact, the ancillary joint venture ruling is an acknowledgement by the IRS that no private benefit issues are raised in economic transactions that involve "insubstantial" services, then the proposed failure to conserve analysis might actually complicate life for exempt entities a bit. The reason for this is that I would classify many ancillary partnership transactions as involving core services. Certainly a hospital that opens an outpatient surgery center in a joint venture with doctors is providing "core services" (e.g., health services to patients) through an economic arrangement with for-profit partners. Moreover, transactions such as the "revenue

⁹⁴ The IRS has provided guidelines in Rev. Proc. 96-32, 1996-1 C.B. 717, for determining when a low-income housing project should be considered a charitable activity. If the partnership adheres to these guidelines, then one might conclude that the partnership activity itself is a charitable activity, much as one might conclude that a hospital operated by an exempt/for-profit partnership would be a charitable activity if the hospital met all of the requirements of Rev. Rul. 69-545, as re-interpreted by the 10th Circuit in *IHC Health Plans v. Commissioner*, 325 F.3d 1188 (10th Cir. 2003).

⁹⁵ See Allen and Duffy, *supra* note 91, at 321 ("Equity financing is an important component of the financing package.").

stream” partnerships involved in GCM 39862 are exactly the ones that should raise some eyebrows, because the charity (the hospital) is giving up a future revenue stream (a significant charitable asset) in a transaction with for-profit investors.⁹⁶ Accordingly, it seems appropriate to require the charity in these cases to justify the transaction on the basis that it permits an expansion, improvement or (in appropriate circumstances) the maintenance of services to the charitable class.

In most of these cases, however, I would expect that the exempt organization would have little trouble meeting the “reasonable justification” requirement. Ancillary partnerships almost always have a purpose of either keeping current services intact or expanding services to the charitable class and almost universally are undertaken in order to accomplish those goals at least financial risk to the charitable entity. Hospitals, for example, undertake ancillary partnerships with doctors in order to insure that the facilities are fully utilized and that the doctors have a direct financial stake in the success of the services.⁹⁷ The ancillary partnership ruling (Rev. Rul. 2004-51⁹⁸) itself involved a situation in which a university proposed to expand services to students via a distance-learning joint venture. It is highly unlikely, therefore, that these transactions generally suffer from a “failure to conserve” charitable assets (in fact, just the opposite is true).

In one aspect, moreover, the failure to conserve analysis would be more generous than past IRS precedents: it would overturn the IRS’s position in GCM 39862 that entering into transactions to improve revenues or to retain relationships with doctors violates the private benefit doctrine.⁹⁹ If, in fact, an exempt hospital can justify a revenue stream joint venture as a means of improving facility utilization (and hence improving the bottom line of the hospital and thus “conserving” more assets for use on the charitable

⁹⁶ See text at notes 34-36, *supra*, for a discussion of this memorandum.

⁹⁷ See MANCINO, *supra* note 35.

⁹⁸ 2004-22 I.R.B. 974. See text at notes 52-56, *supra*.

⁹⁹ See text at notes 34-38, *supra*. The proposed analysis probably would also overturn the IRS’s conclusion in Rev. Rul. 97-21 that recruitment of physicians from within a hospital’s geographic area must be justified by “expanding” a hospital’s services or replacing key existing services. Under the analysis for private benefit I have proposed here, a hospital that chooses to recruit a local physician in order to strengthen its revenue base presumably is conserving charitable assets (expanding revenues available for charitable services), not wasting them (at least as long as the compensation package is “reasonable” under the circumstances).

class) or as a necessary method of keeping physician affiliations (without which the hospital would fail economically, leaving no assets available for use for the charitable class), then I see no reason not to let these arrangements continue.

To summarize, therefore, I would apply the “failure to conserve” analysis equally across all types of joint ventures, be they “whole” or “ancillary.” While this approach would impose somewhat more scrutiny on ancillary partnerships than was undertaken in Rev. Rul. 2004-51 (at least in cases where the ancillary partnership involves core services), the advantage would be that the analysis of private benefit issues would be consistent across all joint venture transactions, thus avoiding the need to classify them in to “ancillary” or “non-ancillary” categories, and hence giving the IRS an escape from the unpleasant corner it may have found itself painted into with the current private benefit analysis. Instead, the only question one would ask from a private benefit standpoint with respect to joint ventures is whether the venture involves core services.¹⁰⁰ At the same time, charities would benefit from a somewhat broader view of the appropriate justifications for these transactions,¹⁰¹ giving them more flexibility to arrange their economic affairs in a way that truly preserves the maximum assets for serving charitable beneficiaries.

3. Credit Counseling and Downpayment Assistance

The recent examples of the IRS’s use of the private benefit doctrine in dealing with exempt credit counseling and downpayment assistance organizations appear to fit my analytical model. In the credit counseling cases, my implementation of private benefit almost certainly would reach the same results as the IRS reached. This is mostly a moot point today given the enactment of Section 501(q), but the analysis is still instructive. The credit counseling agencies are a classic case of outsourcing core (and not-so-core) services to for-profit affiliates, who then profit from the fees paid to them by the agency or directly

¹⁰⁰ Incidentally, my proposed formulation of private benefit explains why the IRS may be justified in its special scrutiny of joint ventures: most of them in fact do involve outsourcing “core services” to the new venture which had previously been performed by the charitable entity alone and thus implicate my “outsourcing” paradigm.

¹⁰¹ That is, hospitals could do these transactions solely to increase utilization rates or improve the hospital’s revenues, a rationale that the IRS rejected as sufficient in GCM 39862.

by the agency's charitable beneficiaries.¹⁰² This profit flow is similar to my original hypothetical of the hospital that outsources nearly all its services. Because I doubt that the agencies could come up with a compelling explanation for why these complex outsourcing arrangements are more efficient in educating their beneficiaries about debt management, the IRS conclusion in the Chief Counsel's memo discussed earlier that the economic arrangements between credit counseling agencies and the "back-office service providers" violate the private benefit proscription likely would hold true under the analytical model I suggest in this paper.

With respect to the downpayment assistance organizations, my analysis requires a more rigorous rationale than what the IRS publicly presented in Situation 2 of Rev. Rul. 2006-27. Recall that the IRS's main problem in Situation 2 was that the organization in question used a circular cash flow to help its beneficiaries – that is, the money to provide downpayment assistance came from the seller of the property.¹⁰³ According to the IRS, this meant that the exempt organization really was more interested in facilitating private housing sales than helping a charitable class, thus violating the private benefit doctrine. A circular cash flow standing alone, however, does not present a good rationale for revoking exemption. If all that was happening in these cases is that the exempt organization was providing a conduit to connect needy families with housing sellers anxious to market their goods, it would be hard to see the problem with these transactions. After all, the charitable beneficiaries would be served in these cases by getting the downpayment assistance and the sellers presumably would get market price for their housing. Who cares if the money to make the arrangement work comes from the seller? After all, one doubts that the IRS would have a problem with the Bill and Melinda Gates Foundation making a \$1 million grant to a school to help finance the acquisition of computers that just happen to run the Microsoft Windows operating system.

But some investigation of the background of this ruling reveals that the real concern is not the circular cash flow *per se*; rather it is that in these cases the charitable

¹⁰² See text at notes 57-59, *supra*.

¹⁰³ See text at notes 60-61, *supra*.

organization is being used as a “front” to funnel charitable beneficiaries to sellers in order to increase the sellers’ market share and hence profits from their sales; according to the General Accounting Office, these circular transactions often resulted in the charitable beneficiaries paying 2-3% *more* for a house than in a non-assisted transaction.¹⁰⁴ In other words, in these cases the charitable organization has contractual agreements with for-profit entities in which the charitable organization agrees to exploit its beneficiaries in order to enhance the revenues of its for-profit partners. These transactions, therefore, fit the “exclusive dealing” paradigm in which the charity essentially transfers some portion of the value of its relationship with its charitable beneficiaries to its for-profit partners – that is, the charity contractually agrees to “guide” its beneficiaries into transactions that produce a supranormal profit for the for-profit seller. In short, the charity is giving up value that should be preserved for the charitable class. Under the approach outlined in this paper, unless these organizations could come up with a persuasive rationale for why steering their charitable beneficiaries into transactions that will cost them more than the normal market value is good for society, they should not be exempt.

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

4. Non-economic Benefits: American Campaign Academy

Suppose that Intel Corporation decides tomorrow that there is a woeful lack of computer engineers skilled in applied circuit design of the type that Intel most needs. To remedy this situation, Intel donates a wad of cash to fund a new educational organization,

¹⁰⁴ See, e.g., Internal Revenue Service, *IRS Targets Down-Payment-Assistance Scams; Seller-Funded Programs Do Not Qualify As Tax Exempt*, IR-2006-74, May 4, 2006 available at <http://www.irs.gov/newsroom/article/0,,id=156675,00.html>; Government Accountability Office, *Mortgage Financing: Additional Action Needed to Manage Risks of FHA-Insured Loans With Down Payment Assistance*, November, 2005, at 22, available at <http://www.gao.gov/highlights/d0624high.pdf>

the Santa Clara Graduate School of Computer Circuit Design, which is dedicated to training computer engineers in exactly the kind of applied circuit design that Intel most needs. One of the three members of the board of this new entity is a senior Intel computer engineer; another is a free-lance engineer who often consults with Intel. The third is a local community leader.

The curriculum of the school is set up specifically to train computer engineers in the applied skills that Intel needs. Many of the professors are former or current Intel engineers and it so happens that most of the graduates of this new school are employed by Intel (not surprising, given the objectives and curriculum of the school). But not all the graduates are employed by Intel, and there is no agreement between the school and Intel under which Intel gets an unfair “first crack” at school graduates – they can work for whomever they want, though their skills are especially suited to Intel’s working environment. In short, there is no contractual or economic arrangement that might be a case of a charity “under-charging” for giving a competitive advantage to a for-profit enterprise, but neither is there any question that the school in fact benefits Intel by training engineers in precisely those skills most needed by Intel.

Should my hypothetical school be tax-exempt? In this scenario, what exactly could be the complaint to bar the school from tax exemption? Education by its nature benefits private interests; Silicon Valley certainly benefits from the close proximity of Stanford, but no one suggests it should lose tax exemption as a result. Many technical and professional training programs serve as “pipelines” to particular employers; a large proportion of the top graduates of my law school, for example, end up being employed by a dozen large Chicago law firms. Does that make the U of I College of Law guilty of prohibited private benefit (legally irrelevant, since we are exempt as part of state government rather than under 501(c)(3), but an interesting question nonetheless)? One might argue that training individuals in skills that primarily benefit a single employer (as opposed to multiple employers) is not charitable, but that certainly is not the definition of “educational” in the Treasury Regulations, which states that “instruction or training of the individual for the

purpose of improving or developing his capabilities” is charitable.¹⁰⁵ Moreover, even a first-year law student would recognize the “slippery slope” problems inherent in such a line – is two employers enough? Three? Four?

The facts of my Intel hypothetical mirror the actual facts of *American Campaign Academy*,¹⁰⁶ and I have yet to figure out why the case was decided as it was (other than possibly a misplaced view that the whole operation somehow violated the prohibitions against political campaign activity, which simply was not true¹⁰⁷). The notion that ill-defined “secondary” benefits somehow should override the very real primary educational purpose of ACA did not have any basis in the law at the time ACA was decided, and still makes no sense. ACA graduates were not required to work for Republicans and some, apparently, did not (the opinion notes that at least one graduate worked for a candidate overseas).¹⁰⁸ Even if one would view training that primarily benefited a single employer as incompatible with tax exemption, in the ACA case the students went to work for multiple employers (individual candidates, not the Republican Party as an entity). The decision fares no better under my “failure to conserve” rationale. Without some economic arrangement that confers a competitive advantage to the Republican Party beyond the advantage conferred by simply training students with the appropriate skills (an advantage conferred on all employers by all educational organizations), it is difficult to see how the fact that ACA graduates were overwhelmingly employed by Republican candidates involved some failure to conserve charitable resources. ACA could not have “charged” the Republican Party or Republican candidates a higher price for its services, since ACA was not providing any services to the Republican Party or candidates to charge them for.¹⁰⁹

¹⁰⁵ Treas. Reg. 1.501(c)(3)-1(d)(3).

¹⁰⁶ 92 T.C. 1053 (1989).

¹⁰⁷ Judge Nims complained in his opinion about the failure of ACA to operate in a “nonpartisan” manner, *id.* at 1070-71, but the IRS conceded that ACA did not violate either the lobbying or campaign activity restrictions. *Id.* at 1063. Charitable organizations do not have to be “nonpartisan” in the sense of being politically neutral in everything they do; they only have to avoid participating in political campaigns or doing “more than an insubstantial” amount of political lobbying. See I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(3)-(1)(c)(3) (defining “action” organizations).

¹⁰⁸ 92 T.C. at 1060.

¹⁰⁹ I might approach this case differently if there was some contractual arrangement between ACA and the Republican Party that required ACA to supply the Republican party with a certain number of qualified campaign operatives or permitted the Republican Party to have some kind of special access to graduates that

Accordingly, if one adopts the “failure to conserve assets” rationale for the private benefit doctrine, ACA almost certainly is wrongly-decided.

5. *United Cancer Council*

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

Though the *United Cancer Council* case was settled and hence never retried on the private benefit point, one could easily trace how the case might be analyzed under my “failure to conserve” approach. UCC’s entering into an exclusive arrangement with a for-profit fundraiser would raise private benefit concerns inasmuch as fundraising is not a routine business transaction and directly affects UCC’s ability to engage in core services for its charitable beneficiaries. This in turn would then trigger the requirement that UCC have a reasonable justification for why it entered into a contract that gave the fundraiser over 90% of the gross amount raised. Because the case was settled, the answer is unclear –

was denied to other potential employers, or if ACA hired only Republican National Committee members as its faculty and licensed only Republican campaign literature from the National Committee for use in its classes. In such a case, one might argue that ACA had improperly “outsourced” core services (teaching and training materials) or inadequately charged for a competitive advantage (exclusive access to students). Compare, for example, my analysis of Example 3 in the IRS’s proposed regulations on private benefit in the text at note 125, *infra*. Despite my views of the ACA case, I admit that one could view the overall relationship between ACA and the Republican Party as being highly “incestuous,” particularly given the makeup of the governing Board of ACA and the predominance of Republicans on its admissions committee. I do not discount the fact that if my test for private benefit were used, additional fact development in the case might have revealed that there were “side deals” in place between ACA and the Republican Party that might have conferred a competitive advantage on the Party. This is precisely why my approach to private benefit is needed; rather than get by with vague assertions of too cozy a relationship between a charity and a for-profit entity, the IRS should be forced to make at least a *prima facie* case why the relationship has stripped charitable beneficiaries of resources. These facts might or might not have existed in the ACA case; we will never know, since the current state of private benefit doctrine permits the IRS to make sloppy accusations with little, if any, rigorous analysis.

but I note that a variety of charities have far lower fundraising costs,¹¹⁰ and therefore it is not unreasonable to presume that UCC could have done better (and thus conserved more assets for its charitable purpose) either by taking fundraising in-house or by contracting with a different outside fundraiser.

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

One of the more vexing problems recently faced by the IRS and charities is how to handle disaster relief in a manner consistent with charitable purposes. Disaster relief has long been recognized as a charitable purpose,¹¹¹ but after the Oklahoma City bombing and again after the 9/11 attacks, questions arose about the ability of charities to make economic grants (in the form of cash or property) to individuals who have suffered from a disaster, particularly if such grants were not to those traditionally classified as “poor” or under some other specific financial need.¹¹² At one point, the IRS had suggested that such grants might violate the private benefit doctrine, stating in a letter to Oklahoma City charities after the bombing there that although one did not have to be “poor” to be eligible for disaster relief, “an outright transfer of funds based solely on an individual’s involvement in a disaster or without regard to meeting the individual’s particular distress or financial needs would result in excessive private benefit.”¹¹³ After the 9/11 attacks, however, the IRS issued Notice 2001-78 stating that it would treat payments made by charities to disaster victims and their families as related to the charity’s exempt purpose as long as such grants were made “in good faith using objective standards.”¹¹⁴ Nevertheless, the private benefit issue raised enough concern that after 9/11, Congress enacted legislation that specifically provided that cash grants to 9/11 victims would be considered as made for an exempt purpose, essentially removing the private benefit analysis from

¹¹⁰ See, e.g., Association of Fundraising Professionals, Fundraising Costs: Size, Age Matter , available at http://www.afpnet.org/ka/ka-3.cfm?folder_id=2345&content_item_id=12886 (last visited 3/3/2006) (recent study of fundraising costs showed average costs to be \$.24 on every \$1).

¹¹¹ Robert A. Katz, *A Pig in a Python: How the Charitable Response to September 11 Overwhelmed the Law of Disaster Relief*, 36 IND. L. REV. 251, 266-67 (2003); Catherine E. Livingston, *Disaster Relief Activities of Charitable Organizations*, 35 EXEMPT ORG. TAX REV. 153 (2002).

¹¹²See JAMES J. FISHMAN & STEPHEN SCHWARZ, TAXATION OF NONPROFIT ORGANIZATIONS 124-26 (3d ed. 2010).

¹¹³ Livingston, *supra* note 110, at 154; see Katz, *supra* note 110 at 286-87;

¹¹⁴ IRS Notice 2001-78, 2001-50 I.R.B. 1.

payments made for 9/11 disaster relief.¹¹⁵ The current IRS position on disaster relief, however, appears to have returned to the proposition that the charity must make some kind of “needs” assessment when appropriate and to document the basis for its grants.¹¹⁶

In two articles published in 2003, Professor Robert Katz argued that both state charity law and the federal tax private benefit doctrine should be read to prohibit charities from conferring excessive financial benefits on their beneficiaries in the context of disaster relief.¹¹⁷ Although this situation does not fall squarely into one of my two paradigms identified above, using the “failure to conserve” rationale for private benefit validates Professor Katz’s conclusions; it also confirms both that the IRS approach of requiring some needs assessment and documentation is exactly correct and that the legislative approach to the 9/11 disaster was too broad.¹¹⁸ Providing grants and other assistance to disaster victims certainly would come within the scope of “core services” that a charity would provide to beneficiaries and hence would invoke my failure to conserve analysis. The question that this analysis poses is how a charity can best conserve charitable assets for use across the charitable class. If the charitable class is a set of disaster victims, a charity should make some reasonable effort not to over-compensate individual victims, since doing so wastes charitable assets that might be used for other victims (or other disasters). As a result, charities in these situations should adopt a set of guidelines for making such grants that are geared toward making sure individual victims are not overcompensated at the expense of other victims.¹¹⁹ Needs assessment and documenting the basis for the relief

¹¹⁵ Victims of Terrorism Tax Relief Act, P.L. 107-134, Section 104 (2002). See FISHMAN & SCHWARZ, *supra* note 123, at 167; Katz, *supra* note 110 at 292-93; Livingston, *supra* note 110, at 154.

¹¹⁶ INTERNAL REVENUE SERVICE, PUBLICATION 3833: DISASTER RELIEF 7-9 available at <http://www.irs.gov/pub/irs-pdf/p3833.pdf> (last viewed 3/1/2006).

¹¹⁷ Katz, *supra* note 110; Robert A. Katz, *Too Much of a Good Thing: When Charitable Gifts Augment Victim Compensation*, 53 DEPAUL L. REV. 547 (2003) (hereafter, *Too Much of a Good Thing*).

¹¹⁸ See Katz, *supra* note 110, for a much more thorough analysis of the 9/11 situation that generally agrees with the observation in the text (*see id.* at 331-333).

¹¹⁹ For example, Gene Steuerle has suggested that charities in this situation need not “operate like ships in uncharted waters” and should take into account issues of progressivity (providing progressively more relief to the less economically-well off) and horizontal equity (making sure that victims in similar economic circumstances receive similar assistance). Gene Steuerle, *Charities and Disaster Relief*, 35 EXEMPT ORG. TAX REV. 159 (2002). In *Too Much of a Good Thing*, Professor Katz distinguished between the objectives tort law and charity law, noting that while tort law strives to make a person whole, there is nothing inherently charitable about that objective, and that by contrast, “loss alleviation ceases to be charitable . . . if it disburses

grant should satisfy us that the charity is not “negligently” making overcompensatory grants to individuals, and thus would satisfy the “failure to conserve” analysis.

7. *The Regulations Examples*

Finally, we should compare the “failure to conserve” rationale with the examples the IRS has presented in the new regulations cited in the introduction.¹²⁰ The first example is an organization whose purpose is to trace the genealogy of a single family.¹²¹ This example, which concludes that the organization fails the private benefit analysis, is simply a restatement of the classic common-law version of private benefit that relates to the size of the charitable class. While I have no objection to using private benefit in this manner, it creates unnecessary confusion when a single concept such as private benefit is used to describe two very different substantive analyses. For purposes of clarity, I would prefer, therefore, that the IRS eliminate this as an example of “private benefit” and instead use it as an example of a failure of charitable purpose (e.g., the organization in question has no charitable purpose, because a charitable purpose requires serving a broad charitable class).

The second example deals with an art museum that displays and sells only art created by “a group of unknown but promising local artists.”¹²² The organization has an independent board, which presumably selects the works for display (although the example does not specifically state this) but artists set their own prices for the art, and the organization receives a 10% “commission” from sales to cover its operating expenses. The example concludes that the direct benefits (the receipt of 90% of the sales price) of the art constitutes an impermissible private benefit.¹²³

more cash than necessary to relieve the victim’s financial distress.” Katz, *Too Much of a Good Thing*, *supra* note 128, at 550. Accordingly, the charitable purpose of disaster relief must necessarily focus on simply relieving financial distress of victims, not granting them compensatory tort damages.

¹²⁰ Treas. Reg. 1.501(c)(3)-1(d)(1)(iii), Example 1.

¹²¹ *Id.*

¹²² *Id.*

¹²³ The example states “Because [the organization] gives 90 percent of the proceeds from its sole activity to the individual artists” the organization fails the private benefit analysis – indicating that the private benefit

While I might prefer to analyze this case as a primary purpose/commercial activity problem,¹²⁴ I also believe the facts of this example would fit the second paradigm of the failure to conserve rationale, where an exempt charity has entered into a contract giving individuals or a for-profit entity a competitive advantage that the charity may have undercharged for (the competitive advantage here is a place to display and a mechanism to sell art that is limited to the works of the local artists, in place of them displaying/selling their art through normal commercial channels). Under my proposed analysis, therefore, the charity would be required to present a reasonable justification for why this arrangement appropriately conserves charitable assets for use across the charitable class. Although the example obviously does not address this final step, I could imagine that such a justification would be difficult to come up with – for example, it seems that a reasonable justification under these circumstances would require the organization to compare its financial arrangements with those of other art galleries; the 10% commission may well be “below market” and hence the gallery in this case would not properly be preserving assets for the charitable class (which in this case is presumably the general community that gets to view and buy the art in question).¹²⁵

Finally, example 3 deals with an educational organization (“O”) whose sole activity is to train individuals in a “program” owned by for-profit company K.¹²⁶ O licenses the program from K, and contracts with K to provide the training faculty and course materials. Any new course materials developed by O must be assigned to K at no charge if the nonprofit ever terminates its license with K. K also sets the tuition charged by O. Not surprisingly, the IRS concludes that this arrangement violates the private benefit

failure is not because of the limited charitable class, but rather because of the economic benefits flowing to the artists. Treas. Reg. 1.501(c)(3)-1(d)(1)(iii), Example 2.

¹²⁴ It appears that the organization in this example is indistinguishable in its activities from any commercial art gallery. As I note in my discussion of joint ventures, if an organization’s primary activity is simply to run a commercial business, then the organization is not exempt for lack of a primary charitable purpose. See, e.g., Treas. Reg. 1.501(c)(3)-1(e).

¹²⁵ That the commission is below market is suggested by Rev. Rul. 76-152, 1976-1 C.B. 151, which has almost identical facts to this newly-proposed example. In that ruling, the IRS noted that the commission charged was “substantially less than customary commercial charges.” If true, this would mean that the gallery in question was failing to get adequate compensation for its services from the artists, and thus is failing to conserve assets for the charitable class.

¹²⁶ Treas. Reg. 1.501(c)(3)-1(d)(1)(iii), Example 3.

doctrine. The failure to conserve analysis likely would reach a similar result. This example seems to be a combination of my two failure to conserve paradigms, involving both a contract with a for-profit conferring a competitive advantage on that for-profit (the licensing arrangement giving K free access to improvements made by O upon termination of the license) and the “outsourcing” paradigm (because O contracts with K for faculty and materials). As with example 2, I would expect that it would be difficult for O to come up with a reasonable justification for this arrangement based upon comparable operations of other educational organizations, which likely do not “outsource” all their teaching nor give away valuable course improvements.

In sum, therefore, the latter two examples in the proposed regulations appear compatible with the failure to conserve analysis, although Example 2 would require additional fact development that is currently lacking. This in turn illustrates that my proposal will not radically alter the results reached in most private benefit cases, but will provide a specific, articulated rationale that charities can actually understand and apply to specific circumstances.

IV. Summary

The current state of doctrine regarding private benefit is a mess. Even the Treasury Regulations apply the term to at least two distinct analytical paradigms, one involving the size of the charitable class and two involving economic arrangements with third parties. A review of private rulings and cases indicates that neither the courts nor the IRS really know what the phrase “private benefit” means. This article illustrates that there can be a well-defined version of private benefit that is useful in filling analytical gaps between the primary purpose requirement and private inurement/§ 4958 analysis. The version of private benefit sketched here, with a rationale linked to failure to conserve charitable assets and a doctrinal implementation focused primarily on two paradigms dealing with core services (the “outsourcing” paradigm and the “competitive advantage” paradigm), likely would reach similar end results as many of the IRS rulings and cases (though not all,

as my analysis of *American Campaign Academy* and GCM 39862 indicates), but does so by providing a rigorous rationale and analytical framework that the doctrine currently lacks. There is no reason to let the IRS substitute an overbroad private benefit doctrine for hard analysis of the true evils of transactions between exempt organizations and for-profit ones, just as there is no reason to make charities or their tax advisors operate in analytical darkness when daylight works just as well.