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January 9, 2006

Hon. Mark W. Everson  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments Concerning Proposed Regulations Under Sections  
501(c)(3) and 4958 of the 1986 Internal Revenue Code

Dear Commissioner Everson:

Enclosed are comments concerning proposed regulations under sections 501(c)(3) and 4958 of the 1986 Internal Revenue Code. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Dennis B. Drapkin  
Chair, Section of Taxation

Enclosure

cc: Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Treasury Department  
Donald L. Korb, Chief Counsel, IRS  
Michael J. Desmond, Tax Legislative Counsel, Treasury Department  
Catherine Livingston, Assistant Chief Counsel (TE/GE), IRS

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**COMMENTS CONCERNING PROPOSED REGULATIONS UNDER  
SECTIONS 501(c)(3) AND 4958 OF THE 1986 INTERNAL REVENUE CODE**

These comments (“Comments”) on the proposed regulations under sections 501(c)(3) and 4958,<sup>1</sup> are submitted on behalf of the American Bar Association Section of Taxation. These Comments also reflect substantial input from the American Bar Association Section of Health Law. The views expressed herein have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by David A. Levitt and Lauren K. Mack. Substantive contributions were made by Kelly R. Berg, Michael A. Clark, David M. Flynn, and James P. Joseph. These individuals are members of the Section of Taxation’s Committee on Exempt Organizations and/or the Health Law Section’s Tax and Accounting Interest Group. The Comments were reviewed on behalf of the Section of Taxation by LaVerne Woods, Chair of the Committee on Exempt Organizations, James K. Hasson, Jr. for the Section of Taxation’s Committee on Government Submissions, and by Richard S. Gallagher, the Council Director for the Committee on Exempt Organizations. The Comments were reviewed by Frederick J. Gerhart on behalf of the Health Law Section.

Although the individuals who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such participant (or the firm or organization to which such participant belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: January 9, 2006

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<sup>1</sup> Reg.111257-05, 70 Fed. Reg. 53599. The proposed regulations will be referred to herein as the “2005 proposed regulations” and citations to particular sections of the proposed regulations will reference the regulations as “Prop. Reg.” References to previously proposed regulations under section 4958 will follow a similar citation format identifying the year the regulations were proposed. References to the temporary (2001) and final (2002) section 4958 regulations will generally omit any date reference.

## INTRODUCTION

To be described in section 501(c)(3) of the Internal Revenue Code of 1986 (“Code”), an organization must, among other requirements, be organized and operated exclusively for religious, charitable, scientific, educational, or other specified exempt purposes. Existing regulations under section 501(c)(3) were adopted in substantially their present form in 1959 (the “existing regulations”).<sup>2</sup>

Treas. Reg. section 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for one or more enumerated exempt purposes unless it serves a public rather than a private interest. To satisfy this requirement, the organization must 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 interests. These provisions of the existing regulations are the primary source of the “private benefit” doctrine applied by the Internal Revenue Service (the “Service”) and the courts. As recognized by a number of judicial decisions, the “private benefit” doctrine under the regulations is separate and distinct from section 501(c)(3)’s statutory prohibition on inurement of the organization’s net earnings to the benefit of shareholders or other private individuals, or “private inurement.” See, e.g., *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989). The 2005 proposed regulations add several examples, which the preamble indicates are intended to illustrate the application of the “private benefit” provisions of the existing regulations.

Section 4958 of the Code was enacted on July 30, 1996. The report of the House Ways and Means Committee addressed the relationship between section 4958 and section 501(c)(3), stating that intermediate sanctions may be imposed by the Service in lieu of or in addition to revocation of the organization’s tax-exempt status.<sup>3</sup> The committee report further stated, in a footnote, that in general, revocation of tax-exempt status would occur only if an organization no longer operates as a charitable organization.<sup>4</sup>

The 1998 proposed regulations under section 4958 stated that the section 4958 excise taxes do not affect the substantive standards for exemption under section 501(c)(3).<sup>5</sup> The preamble to the 1998 proposed regulations further stated that the Service would exercise its administrative discretion in enforcing the requirements of section 4958 and section 501(c)(3) and listed four factors the Service would consider in determining whether an organization described in section 501(c)(3) continues to be exempt.<sup>6</sup>

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<sup>2</sup> T.D. 6391, 1959-2 C.B. 139.

<sup>3</sup> H. Rep. No. 104-506, 104<sup>th</sup> Cong., 2d Sess. 59 (1996), 1996-3 C.B. 49, 107.

<sup>4</sup> *Id.* at 59, n. 15.

<sup>5</sup> 1998 Prop. Reg. § 53.4958-7(a), 1998-2 C.B. 244.

<sup>6</sup> Preamble to Reg. 246256-96, 1998-2 C.B. 224, 226.

The temporary regulations and the final regulations under section 4958 also included a statement that the section 4958 excise taxes do not affect the substantive standards for exemption under section 501(c)(3) and that regardless of whether a particular transaction is subject to excise taxes under section 4958, “existing principles and rules may be implicated, such as the limitation on private benefit.”<sup>7</sup> The preamble to the temporary regulations stated that the Service intended to publish guidance regarding the factors it would consider as it gained more experience in administering section 4958.<sup>8</sup> The preamble to the final regulations stated that, until such guidance was published, the Service would consider all the facts and circumstances.<sup>9</sup>

The 2005 proposed regulations continue the constructive process of providing administrable guidance with respect to section 4958. They also provide helpful clarification on the factors the Service will consider in determining whether an organization that engages in one or more excess benefit transactions continues to be exempt.

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<sup>7</sup> Treas. Reg. § 53-4958-8T(a), 2001-1 C.B. 683; Treas. Reg. § 53.4958-8(a).

<sup>8</sup> T.D. 8920, 2001-1 C.B. 654, 667.

<sup>9</sup> T.D. 8978, 2002-1 C.B. 500, 506-7.

**Comments on Prop. Reg. § 1.501(c)(3)-1(d)(1)(iii):  
Determining Whether an Organization Serves a Public Rather Than a Private Interest**

The 2005 proposed regulations add a number of examples intended to illustrate whether an organization serves a public rather than a private interest within the meaning of section 1.501(c)(3)-1(d)(1)(ii) of the regulations. We agree that the organizations in the examples do not qualify as organizations described in section 501(c)(3). We are concerned, however, that the addition to the regulations of the three relatively narrow examples proposed (which are, for the most part, already addressed by existing authorities<sup>10</sup>), without further explanation in the regulations of the parameters of the “private benefit” doctrine and the methodology for its analysis and application, is likely to produce more confusion than clarification.<sup>11</sup> The new examples describe organizations which do not qualify for exemption, possibly for several reasons. The first two examples raise the issue of whether the organization is predominantly organized and operated to further an educational purpose, although the extent to which any “education” within the meaning of section 1.501(c)(3)-1(d)(3) of the regulations is being provided is not made clear. The third example raises the issue of whether someone other than a member of the recognized class of beneficiaries receives a more than insubstantial financial benefit, although certain terms of the license agreement discussed also seem likely to lead to prohibited “private inurement” of O’s net earnings for the benefit of P.

The question of public versus private benefit potentially raises two discrete issues: (1) whether an organization’s activities qualify as charitable or educational in the first instance, considering, among other factors, whether a recognized charitable class is being served by the organization; and (2) whether someone other than a member of the recognized class being served by the organization receives a more than insubstantial private benefit, typically financial in nature. The principles underlying a determination of what constitutes an appropriate charitable class look to factors such as the specific activity engaged in by the organization and the potential breadth of the class. The principles to be considered in evaluating whether someone is receiving an impermissible private benefit look to factors such as whether the transaction or arrangement is occurring at fair market value and whether any benefit is both qualitatively and quantitatively incidental to the achievement of the organization’s exempt purposes.<sup>12</sup>

We suggest that, rather than add three isolated examples to the regulations, the Service consider a broader revision of the regulations to provide a more detailed discussion of

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<sup>10</sup> See, e.g., *Callaway Family Association v. Commissioner*, 71 T.C. 340 (1978), and *Manning Association v. Commissioner*, 93 T.C. 596 (example 1); *est of Hawaii v. Commissioner*, 71 T.C. 1067 (1979) (example 3); *but see Goldsboro Art League v. Commissioner*, 75 T.C. 337 (1980) (example 2).

<sup>11</sup> The preamble to the proposed regulations also suggests that a prohibited private benefit need not be financial. All of the examples in the proposed regulations appear, however, to involve some financial benefit, and the preamble does not cite any authority in support of its assertion that a financial benefit is not required. In cases where such an assertion has been made, the courts have been reluctant to find a substantial private benefit. See, e.g., *Nationalist Movement v. Commissioner*, 102 T.C. 558, 575, *aff’d per curiam*, 37 F. 3d 216 (5<sup>th</sup> Cir. 1994).

<sup>12</sup> See, e.g., GCM 37789 (December 18, 1978)

the underlying principles of the private benefit doctrine discussed above. The relative quantity of private benefit which would preclude exemption should be addressed. In this regard, the peculiar inconsistency between the standards articulated in the first ("primarily") and second ("more than an insubstantial part") sentences in section 1.501(c)(3)-1(c)(1) of the regulations has long been acknowledged by the Service to require reconciliation.<sup>13</sup>

### **Comments on Prop. Reg. § 1.501(c)(3)-1(g): Determining Whether Revocation of Tax-Exempt Status is Appropriate When Section 4958 Excise Taxes Also Apply**

The 2005 proposed regulations enumerate specific factors that the Service will consider in determining whether a section 501(c)(3) organization that engages in one or more excess benefit transactions described in section 4958 will continue to be recognized as exempt under section 501(c)(3). *See* Prop. Reg. § 1.501(c)(3)-1(g)(2)(ii). These factors provide clear and useful guidance. We agree with the decision to include as relevant factors the size and scope of an organization's exempt activities and the organization's efforts to take appropriate corrective action, neither of which were originally included in the preamble to the 1998 proposed regulations.

The 2005 proposed regulations also explicitly state that an organization can help to maintain its tax-exempt status by discovering an excess benefit transaction of its own accord and taking corrective action before recognition and enforcement by the Service. Prop. Reg. § 1.501(c)(3)-1(g)(2)(iii). We believe this guidance should appropriately encourage organizations to monitor their activities carefully, scrutinize potential transactions, and take affirmative action when necessary to reverse any excess benefit transaction that does occur.

The balance of our Comments pertain primarily to the specific examples provided in section 1.501(c)(3)-1(g)(2)(iv) of the 2005 proposed regulations. The five examples fairly and clearly describe the application of the facts and circumstances analysis described in section 1.501(c)(3)-1(g)(2)(ii). However, each example sets forth a situation in which the excess benefit is either significant and repeated or thoroughly corrected or *de minimis*. Further guidance involving situations with less clear facts would be instructive. A number of practitioners have noted that the situations addressed in the examples are not often encountered in practice.

For instance, Examples 1 and 2 set forth opposite ends of the spectrum for dealing with an excess benefit transaction. In the first example, the museum uses almost all of its revenues to purchase art solely from its trustees at prices exceeding fair market value. The museum conducts no other activities that further its exempt purpose and has not attempted to either prevent or correct repeated excess benefit transactions. On the other hand, in the second example this situation has been completely reversed. The entire board resigns and is replaced, the organization no longer purchases art from current or former trustees, and appropriate safeguards have been adopted. The examples do not illuminate how the Service would apply the relevant factors if, for instance, only one or two art dealers were also trustees who sold paintings to the museum, or if the trustees voluntarily returned the excess amounts paid, but the museum did not remove the trustees from the board or take any other corrective action. It would be

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<sup>13</sup> *See, e.g.*, GCM 34682 (November 11, 1971).

helpful if the Service could provide examples analyzing these less obvious circumstances.<sup>14</sup> Below are some questions in particular that we believe are not clearly addressed by the examples provided:

**What does it mean for the size and scope of a transaction to be significant in relation to the size and scope of an exempt organization's activities?** Whether a transaction is significant in the examples is largely assumed. For instance, Example 3 provides that the organization diverted “significant portions” of its funds to pay for personal expenses of the Chief Executive Officer that “significantly reduced the funds available” to conduct educational programs. In Example 4, we know that constructing a building addition was “a significant undertaking” in relation to the exempt organization's activities. These descriptions are conclusory and provide no guidance as to what the Service might consider significant. We recognize that this analysis will depend on the facts and circumstances of each transaction and that there is no specific threshold amount that makes a transaction “significant.” Nevertheless, an example of a “safe harbor” including specific amounts that the Service would consider clearly insignificant, perhaps as a percentage of overall expenditures, would be helpful.

**Are disqualified person's and/or the trustees' knowledge and intention relevant to the analysis?** Most of the examples describe situations where an organization's trustees entered into an excess benefit transaction voluntarily or were aware of the excess benefit transaction. (In Example 4, the board did not conduct the due diligence necessary to make a determination at first, but eventually did become aware of and correct the transaction.) In other situations—probably far more common—the board may not be aware or may not agree that an excess benefit transaction has occurred, and the excess benefits may be completely unintentional. An example addressing a board's knowledge or intention in entering into an excess benefit transaction would therefore be helpful. For instance, would the result be different in Example 1 if the trustees incorrectly believed that a transaction was conducted at fair market value and did not recognize the benefit to be excessive? If an organization can demonstrate that the trustees conducted the appropriate due diligence or followed certain safeguards, these facts should indicate that the excess benefit was unintentional, and this should be a positive factor weighing against revocation.

Along the same lines, an example could demonstrate that trustees who attempted to take the necessary steps to obtain a rebuttable presumption of reasonableness under section 4958, as a result, did not jeopardize the organization's tax-exempt status in the event the Service still finds an excess benefit transaction. Such an example would both emphasize the importance of an organization conducting the appropriate due diligence and encourage use of the rebuttable presumption of reasonableness procedure under section 4958.

**Determination of fair market value.** The examples in the proposed regulations assume that compensation clearly exceeds fair market value. For instance, in Example 4, the exempt organization pays a disqualified person “an amount that substantially exceeded the fair

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<sup>14</sup> Cf. Treas. Reg. § 53.4958-3(g), examples 8 and 9 (comparing a small university academic department to the College of Law), and 10 and 11 (comparing a hospital radiologist to the head of the cardiology department).

market value of the services Company K provided.” Valuation is often the most difficult question in determining whether an excess benefit has occurred. Therefore, an example illustrating how directors attempted (or failed to attempt) to determine fair market value and how this affects the revocation analysis would be helpful. We suggest that the proposed regulations should contain clear guidance that the fact that trustees have made a good faith attempt to determine fair market value for a transaction would ordinarily protect the organization from revocation, even if the Service disagrees with their fair market value analysis.

**Excess benefit transactions that are addressed post-audit.** The regulations make clear that “correction after the excess benefit transaction or transactions are discovered by the Commissioner, by itself, is never a sufficient basis for continuing to recognize exemption.” Prop. Reg. § 1.501(c)(3)-1(g)(2)(iii). Nevertheless, in many cases, an organization may not recognize or agree that an excess benefit transaction has occurred. The organization may, after consideration of the reasoning supporting the Service’s proposed determination, nevertheless be prepared to correct the transaction and adopt safeguards to prevent future abuse. Therefore, we suggest an example illustrating what additional factors, in addition to correction post-audit, would be sufficient to avoid revocation of exemption. Among these factors, we suggest, would be the relative insignificance of the excess benefit in comparison to the magnitude of the organization’s operations or assets.

**Employee compensation arrangements.** No example has been provided specifically addressing reasonable compensation of an employee. We think this is a very likely area for excess benefit transactions to occur. We suggest an example illustrating how the Service would analyze an executive compensation arrangement with respect to the scope of the transaction, whether the transaction was one-time or repeated, and whether the organization had conducted appropriate due diligence (e.g., obtained and relied on an independent compensation analysis).

**Is it necessary to remove disqualified persons in order to implement appropriate safeguards?** In both Example 2 and Example 4, the organizations removed the party receiving the excess benefits, and in both cases the organizations continued to meet the requirements of section 501(c)(3). Example 3 cites as an unfavorable fact that the board did not terminate the chief executive officer’s employment, and the organization’s charitable status in this case was revoked. These examples suggest that anyone involved in an excess benefit transaction should be removed as part of the correction. However, if the organization adopts a conflict of interest policy and other safeguards and the disqualified persons correct previous transactions and avoid future excess benefit transactions, it would appear the organization has taken appropriate steps to avoid revocation. This might be very important to an organization which would risk substantial contract law damages and litigation costs for effecting a termination. The examples also do not address whether removal is a necessary measure in the likely event that an organization and a disqualified person are unaware at the time of the transaction that the agreed-upon compensation would be considered excessive.

**The effect of one non-repeated but significant transaction.** Most examples involve repeated excess benefit transactions. We note that the Tax Court in *Caracci v. Commissioner*, 118 T.C. 279 (2002), did not believe it appropriate in that case “to conclude that the single transaction (as to each entity) underlying the excess value also requires our revocation

of each entity's tax-exempt status." It would be helpful if the Service were to provide guidance regarding when it would consider a one-time excess benefit transaction to jeopardize an organization's tax-exempt status, and what the scope of such transaction might be.

### **Conclusion**

The 2005 proposed regulations provide welcome guidance for organizations faced with potential excess benefit transactions on the part of disqualified persons. Although our Comments have made suggestions for ways in which this guidance might be made more useful, we strongly support the Service's efforts to issue guidance on this important issue. We do not, however, believe that the three examples purporting to illustrate the application of the "private benefit" standard are a helpful addition to the regulations; we suggest that such examples be added only as part of a broader effort to clarify the application of the regulations under section 501(c)(3) of the Code.