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Private Benefit Rules – Part I: Private Benefit Doctrine

By Emily Chan (http://www.nonprofitlawblog.com/author/emily-chan/) on September 27, 2012

(http://www.nonprofitlawblog.com/assets/6a00d834558ca469e2017ee3d1a64e970d-pi)The conferment of private benefits by 501(c)(3) organizations is governed by a set of federal tax laws that are commonly not well understood.Most nonprofit leaders know to be wary of any organizational transaction, arrangement, practice, or policy that may potentially or actually serve private rather than public interests. However, they often struggle in understanding what type and degree of private benefit may be permissible and under what circumstances. Nonprofit leaders can appropriately navigate such concerns by learning the three principal rules that govern public charity private benefit issues: the private benefit doctrine, private inurement doctrine, and excess benefit transaction rules. The first rule, the private benefit doctrine, is discussed in this post.

Private Benefit Doctrine

The private benefit doctrine is the broadest of the private benefit rules in both its applicability and scope. The doctrine applies to any individual to whom the organization may confer a benefit and is not limited to monetary benefits.

The private benefit doctrine is derived from the requirement under section 501(c)(3) of the Internal Revenue Code that an organization be organized exclusively and operated primarily for one or more qualifying exempt purposes (e.g., religious, educational, or charitable). Although "private benefit" is not explicitly referenced in the statute, an organization will fail this requirement if it confers private benefits upon an individual that are more than incidental, quantitatively and qualitatively, to the furthering of its exempt purposes. (See Gen. Couns. Mem. 39862, Nov. 21, 1991.)

The distinction between private and public interests can appear subtle at times but it is an important one for 501(c)(3) organizations to understand. As the IRS notes in an internal publication:

> The distinction between an individual as a private person and the individual as a member of the general public incorporates the following two concepts which are basic to unraveling inurement problems: (1) An individual is not entitled to unjustly enrich himself at the organization's expense. (2) Benefits directed to an individual as a member of a charitable class do not constitute unjust enrichment. (1990 EO CPE Text, "Overview of Inurement/Private Benefit Issues in IRC 501(c)(3) (http://www.irs.gov/pub/irs-tege/eotopicc90.pdf).")

Homeless shelters are classic examples of public charities that confer benefits such as food, clothing, and shelter to individuals as members of a charitable class (http://www.nonprofitlawblog.com/home/2007/01/charitable_clas.html) (e.g., the disadvantaged, underserved, impoverished). However, if a homeless shelter is set up to serve a single person or certain designated individuals, it will be conferring impermissible private benefits to such individuals even if they fit the description of someone who is a member of a typical charitable class.

The private benefit doctrine is a particularly important concept to understand when forming and operating a 501(c)(3) tax-exempt organization. As the Treasury Regulations explain, "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, or persons controlled, directly or indirectly, by such private interests." (Treas. Reg. 1.501(c)(3)-1(d)(1)(ii).) Importantly, the IRS furthermore acknowledges, "genuine public benefit often provides an incidental benefit to private individuals." (2001 EO CPE Text, "Private Benefit Under IRC 501(c)(3) (http://www.irs.gov/pub/irs-tege/eotopich01.pdf).") The key is that such benefit to a private individual must be incidental both qualitatively (i.e., the private benefit is a mere byproduct of the public benefit) and quantitatively (i.e., the private benefit is insubstantial in amount).

Facts and circumstances that commonly raise concerns for the IRS include:

- Serving too small of a class of beneficiaries;
- Entering into transactions on unreasonable or unfavorable terms to the organization;
- Engaging in substantial activities not clearly in furtherance of the organization's exempt purposes;
- Conferring benefits to private parties beyond the scope necessary to further the organization's exempt purposes;
- Establishing exclusive business dealings with a particular for-profit business; and
- Failing to consider alternative sources or comparative prices when purchasing goods and services.

Clearly establishing with the IRS in the organization's Form 1023 exemption application and annual Form 990 information returns its exempt purposes and how it is organized and operated in furtherance of those exempt purposes can be especially critical for organizations that also have certain circumstances that have the potential for private benefit violations such as business relationships with persons in control of the organization, governing bodies composed of a small group of individuals, or a narrow class of intended beneficiaries. While such factors may not necessarily preclude tax-exempt status, a poorly prepared exemption application that fails to address these potential abuses can result in significant delays in processing or, at worst, a denial of tax-exempt status. Additionally, similar mistakes on a Form 990 can lead to an audit, undesirable

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public scrutiny and media backlash, or, in severe cases, a revocation of tax-exempt status.

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