DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,

FROM: ACTING ASSOCIATE CHIEF COUNSEL (EMPLOYEE BENEFITS AND EXEMPT ORGANIZATIONS) CC:EBEO

SUBJECT:

This Field Service Advice responds to your original memorandum dated September 1, 1998, including additional information provided in your supplemental memoranda of September 17, 1998, and October 2, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

B =
C =
D =
E =
F =
G =
H =

q =
r =
s =
t =
u =
v =
w =
x =
w+x =

ISSUE(S):

Does the IRS have sufficient evidence to determine whether C's guaranty of the assets of a blind trust confer an impermissible private benefit or inurement on the beneficiary of the blind trust?

You have characterized this issue as comprising the following two sub-issues:

1. Were the premiums received by C reasonable payment for the risks it assumed?

2. Is the agreement between C and the blind trust a common means of protecting assets in a blind trust?

CONCLUSION:

[redacted]

[redacted] We agree with your statement that the IRS "must learn whether the premiums paid by [F] (through the blind trust) to [C] were reasonable in light of the risks [C] assumed . . ." in order to determine whether the transaction between C and F's blind trust conferred a prohibited benefit on F. [redacted]

[redacted]

[redacted]

FACTS:

In the following summary, and for purposes of this memorandum, we assume the accuracy and validity of the facts described in, and materials and information accompanying, your Request for Field Service Advice.

The of B created C. B’s required C’s trustees

to use the income to maintain the , devoting a portion of each year’s income to support and educate orphans and other indigents, . C has been recognized by the IRS as an organization described in IRC § 501(c)(3).

E is an firm. C, through a for-profit subsidiary, holds an *r* percent interest in E, and has a total investment of $*s* in E.

F was a general partner of E.

. Consequently, E paid F for of F’s interest in cash, and executed a for the remainder of F’s interest. The terms of the were that E promised to pay F the principal amount of F’s remaining interest in E, valued at $*t*, plus interest at a fixed rate, over a stated period of time. The ensured that F did not share in any future profits of E.

. E approved G as the trustee of a trust established for the benefit of F or F’s spouse or children, which then held the issued by E. At some point around the time the was executed, a trustee of C was contacted about entering into a arrangement between C, F and G. C’s only previous relationship with F was by virtue of F’s position as general partner of E. C, through a for-profit subsidiary, held an equity interest in E and had other dealings with E, such as using E for and related services.

C, F, and G subsequently entered into a “ agreement” whereby certain “exercise events” obligated C to purchase the from F or G at a price equal to the sum of 100 percent of the principal amount of the on the date of the purchase, and accrued but unpaid interest to the date of purchase. The only events triggering such a purchase were failure of E to make any payments of principal or interest under the terms of the , or acceleration of the maturity of the .

This arrangement also states that F or G has the obligation to pay to C an annual fee equal to u percent of the principal amount as of the end of E’s preceding fiscal year. Records of C show that G made payments as scheduled in the years included in C’s examination by the IRS. If F or G fails to make the required payments, then C is relieved of any obligation under the arrangement.

During the course of C’s examination by the IRS, F’s counsel also provided the IRS with statements that C was selected as of the for the following reasons: because of C’s sound financial condition and creditworthiness;

and because C had recently conducted an in-depth due diligence review of E in connection with its initial investment (through its for-profit subsidiary), it was willing to enter into the without another such review of E. F’s counsel also stated that the fee sought by C for serving as was competitive with those being sought by alternative .

C has characterized the agreement as a credit enhancement arrangement, analogous to a standby letter of credit. C states that it arrived at the annual fees charged by contacting several banks to gather comparability data for this type of transaction. However, C has not provided the IRS with records to substantiate this comparability data, and has alleged that certain documents are protected by attorney/client privilege. C states that it compared the cost of standby letters of credit charged by several banks for obligors with a credit rating similar to that of E at the time period of the transactions to calculate a range of v to w basis points. C then added a premium of x basis points to the high end of that range, and charged a fee of $(w+x)$ basis points. C stated that the added premium was similar to what other commercial banks would have charged under similar circumstances.

LAW AND ANALYSIS

To qualify for recognition as a tax-exempt organization under the requirements of IRC § 501(c)(3), an organization must be organized and operated so that no part of its net earnings inures to the benefit of any private shareholder or individual. Under Treas. Reg. § 1.501(a)-1(c), a private shareholder or individual is a person with a personal and private interest in the organization’s activities. These private shareholders or individuals (so called “insiders”) are those persons who have an opportunity to control or influence an organization’s activities   because of their particular relationship with the organization.

In most circumstances an unrelated third party is not a “private shareholder or individual” for purposes of the § 501(c)(3) inurement prohibition. *People of God Community v. Commissioner*, 75 T.C. 127 at 133 (1980). The recent case of *United Cancer Council*, 109 T.C. 326 (1997), *appeal docketed*, Nos. 98-2181, 98-2190 (7th Cir. Apr. 30, 1998), analyzed whether an unrelated third party was an insider for purposes of inurement under IRC § 501(c)(3) when that third party negotiated a contract with the exempt organization at arm’s length. In the *United Cancer Council* case, the five year noncancellable contract gave the contractually-related person (a professional fundraising company) extensive control over the organization’s primary source of income. The extent of that control and influence over the organization’s activities and income, as well as the organization’s impaired financial condition at the time of negotiating the contract, were critical elements of the court’s finding of insider status. Under the specific facts of that case, the court did hold the professional fundraiser to be an insider. Additionally, the court found that the contract was not a reasonable contingent compensation arrangement and the insider’s compensation under the contract exceeded reasonable compensation. Therefore the court held that there was impermissible inurement of net earnings to the insider that justified retroactive revocation of the § 501(c)(3) organization’s tax exemption.

[redacted]

Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. In this case, the guaranty of the assets of the blind trust must be evaluated based on whether it conferred an impermissible private benefit on the beneficiary of the trust. “Private benefit” is not clearly defined in the Code or regulations. The concept has been developed in case law, along with the regulatory concept cited above, to require a balancing of the public interest served by the organization’s activities against the private interests served. Similar to the basic inurement analysis, the threshold question is whether the benefit a § 501(c)(3) organization provides to an unrelated third party is a fair market value exchange for the consideration provided by the third party. Only if the party is provided with greater than fair market value (or the organization receives less than fair market consideration for the benefit provided) is private benefit to the third party present. We believe several recent cases evaluating fair market value questions in an inurement context are relevant here.

In *Anclote Psychiatric Center, Inc. v. Commissioner*, T.C. Memo 1998-273, *appeal docketed* (11th Cir. Nov. 13, 1998), the court ultimately decided that petitioner's sale of its hospital for less than fair market value resulted in prohibited inurement within the meaning of § 501(c)(3). In evaluating the sale price, the court viewed its task as merely determining whether that sale price was within a reasonable range of what could be considered fair market values. The court did not find it necessary to determine a precise amount representing the fair market value of the property transferred in that case. In the *United Cancer Council* case discussed earlier, the court used expert witness comparisons of similar contracts in the direct mail fundraising industry to determine whether there was unreasonable compensation under the fundraising contract.

Even where private benefit is present in a transaction with a § 501(c)(3) organization, more than incidental private benefit is required before the organization's exemption is jeopardized. Rev. Rul. 70-186, 1970-1 C.B. 128; Rev. Rul. 75-196, 1975-1 C.B. 155. However, if an organization operates for the benefit of a private interest (a nonexempt purpose) to the extent that more than an insubstantial part of the organization's activities further that nonexempt purpose, the organization is not entitled to exemption from tax under § 501(a). *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989).

If private benefit exists, there is a two-step process to determine if it is sufficient to affect the exempt status of the organization. The first step is to determine the amount of private benefit. In this case the amount of private benefit would consist of any underpayment of the premium for the guaranty below its fair market value. The second step would be to determine whether that private benefit plus any other private benefits are substantial when compared to the public benefit served by the organization.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[1] [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Acting Associate Chief Counsel

By: ______________________________

cc: