**REPORT #739**

**TAX SECTION**

# New York State Bar Association

Report on Exempt Organization Inurement Issues

In the Context of G.C.M. 39862

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TAX SECTION

New York State Bar Association

November 11, 1992

The Honorable Shirley D. Peterson
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
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Dear Commissioner Peterson:

I enclose a report, prepared by the Tax Section's Committee on Tax Exempt Entities, that considers the Internal Revenue Service position on certain issues relating to the inurement to the benefit of private shareholders or individuals of the net earnings of a tax exempt organization as expressed in G.C.M. 39862 (November 21, 1991).[1]

After discussing G.C.M. 39862 and the background of the inurement issue, the report discusses the meaning of “private shareholder or individual”. It then considers the implications of the G.C.M. for certain investments of charitable organizations. Finally, it urges that the issues considered by the G.C.M. should be addressed by proposed regulations.

The drafters of the report would be pleased to meet with your staff at their convenience to discuss the matters considered therein.

Very truly yours,

John A. Corry
Chair

[1]This report was principally prepared by Harvey P. Dale, Franklin L. Green, Ronald A. Lehmann and Ellen O'Donnell. Helpful drafting assistance was received from Kim Blanchard and John A. Corry.

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NEW YORK STATE BAR ASSOCIATION
TAX SECTION

# Report on Exempt Organization Inurement Issues In the Context of G.C.M. 39862

This report, prepared by the Committee on Tax Exempt Entities,[1] considers issues related to the inurement to the benefit of private shareholders or individuals of the net earnings of a tax exempt organization. In particular, it discusses the recently adopted Internal Revenue Service position on these issues as expressed in G.C.M. 39862 (November 21, 1991) (the “G.C.M.”).

## Introduction

Section 501 of the Internal Revenue Code denies tax exempt status to organizations that allow their “net earnings” to inure to the benefit of “any private shareholder or individual.” As we discuss below, although this language is of long-standing origin, its interpretation by both the courts and the Internal Revenue Service has not been clearly defined. The G.C.M. addresses this issue.

The G.C.M. deals with a fairly narrow and well-defined transaction — a hospital's sale of its revenue stream from a certain service or department to a joint venture between the hospital and members of its medical staff. The significance of the G.C.M.'s approach to this transaction, however, extends well

[1]This report was principally prepared by Harvey P. Dale, Franklin L. Green, Ronald A. Lehmann, and Ellen O'Donnell. Helpful drafting assistance was received from Kim Blanchard and John A. Corry.

beyond the context of hospital/doctor joint ventures.[2] The G.C.M. contains the most complete analysis to date of the Service's use of the doctrine of private inurement, both as to the definition of private shareholder or individual and the determination of private benefit.[3] In the benefit context, the G.C.M. raises issues concerning permissible investments by charities that have nothing to do with revenue sales[4]

The G.C.M analyzed and recommended revocation of three private letter rulings (the “PLRs”).[5] In each, the Service had approved a transaction in which a tax-exempt hospital entered into some form of joint venture with staff doctors pursuant to which the doctors had an ownership interest in an entity which purchased some of the hospital's revenue streams. In each, the hospital represented that a significant purpose of the joint venture was to provide an economic incentive for the doctors, through their medical advice and recommendations to their patients, to increase the utilization of the hospital's facilities. In none was there any indication of capital shortage on the part of the hospital, and the G.C.M. states that the

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[2]For discussions of the G.C.M., see Bromberg, IRS Announces New Position on Hospital-Physician Joint Ventures. 5 Exempt Org. Tax Rev. 31 (Jan. 1992); Lipton, IRS Attacks Hospital Joint Ventures. 70 Taxes 59 (Feb. 1992); Mancino, New GCM Suggests Rules for Ventures Between Nonprofit Hospitals and Doctors. 76 J. Tax'n 164 (March 1992).

[3]For other discussions, see Hopkins, The Law of Tax-Exempt Organizations ch. 13 (6th ed. 1992); Note, The “Inurement of Earnings to Private Benefit11 Clause of Section 501(c): A Standard Without Meaning?, 48 Minn. L. Rev. 1149 (1964); Redmond, Annotation, Federal Tax Exemption: When Do Earnings of Religious. Charitable. Educational, or Similar Organization Inure to the Benefit of Private Shareholders or Individuals Within the Meaning of 26 USCS S 501(c)(3). 92 A.L.R. Fed. 255 (1989); and sources there cited.

[4]Unless the context clearly otherwise requires, references to “§” refer to sections of the Internal Revenue Code of 1986, as amended, and references to “Treas. Reg. §” refer to sections of the Treasury Regulations promulgated thereunder.

[5]Private Letter Rulings 8820093, 8942099, and an unpublished 1984 letter.

transactions were not necessary for the financial needs of the hospital. The G.C.M. recommended the revocation of the PLRs[6] that had reached the opposite conclusion.[7]

The analysis in the G.C.M. is divided into three parts. The first discusses the concept of "inurement," the second the notion of "private benefit," and the third certain non-tax legal issues under the Federal rules for Medicare and Medicaid Programs. Our comments are limited to "inurement", to certain implications of the G.C.M. as to the propriety of certain financial activities of charities having nothing to do with hospital revenue sales and to the need for regulating guidance. We generally support the analytical approach of the G.C.M. to the inurement and private-benefit doctrines, but we disagree with the seemingly very broad test used by the G.C.M. for determining "insider" status for purposes of the inurement proscription.

Many types of tax-exempt organizations are forbidden from permitting private inurement or private benefit. The Code language dealing with inurement typically describes a tax-exempt

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[6]Because issues relating to the prospective or retroactive revocation of the PLRs and the extent to which other hospitals were justified in relying upon them are not unique to a consideration of the inurement issue, we do not discuss those questions in this report.

[7]The Service expanded on its conclusions in the GCM in Announcement 92-70, 1992-19 I.R.B. 89, issued on April 21, 1992. The Announcement provides that if an other hospital intended "to rescind" a gross or net revenue stream joint venture, the Service would entertain requests for closing agreements or other arrangements, made by September 1, 1992, that would enable such hospitals to unwind these joint ventures without jeopardizing their tax exemptions. While the Announcement indicates that the Service has backed away from the threat of immediate termination raised in the GCM, in our view the Announcement reflects a lack of appreciation for the difficulties incident to rescission, especially if it must be accomplished in less than four months. We believe that a proposal similar in structure to Announcement 92¬70 would be appropriate if it provided (1) a longer period for unwinding the arrangements and (2) safe harbors enabling a hospital to provide a reasonable return to the doctors participating in the unwinding so that it can be accomplished without jeopardizing the hospital's tax exemption on the grounds of inurement or undue private benefit.

entity as an organization "no part of the net earnings of which inures to the benefit of any private shareholder or individual."[8] Despite its apparent meaning, it has not been limited in application either to shareholders[9] or individuals,[10] nor does the, rule apply only to net earnings.[11]

The applicable regulations are of little assistance. Treas. Reg. Section 1.501(c)(3)-1(c)(2) provides:

[8]This exact language appears in §§ 501(c)(3), 501(c)(6), 501(c)(13), and 501(c)(19)(C). Closely similar but not identical language appears in §§ 501(c)(7), 501(c)(9), and 501(c)(11)(A). No analogous language appears in any of the other 18 paragraphs of § 501(c). In at least one instance, however, the regulations contain similar words even though the statute is silent: Treas. Reg. § 1.501(c)(5)-1(a)(1) provides that § 501(c)(5) entities - i.e., labor, agricultural, or horticultural organizations - must "[h]ave no net earnings inuring to the benefit of any member." Other provisions also use identical or similar language, see, e.g., §§ 170(c)(2)(C), 170(c)(3)(B), 170(c)(5), 526, 528(c)(1)(D), 833(c)(3) (A) (Vi), 2055(a)(2), 2055(a)(4), 2106(a) (2) (A) (ii), 2522(a)(2), 2522(b)(2), 2522(b)(5), and 4421(2) (B)

[9]Indeed, it is quite rare, but not unheard of, for nonprofit corporations to be able to issue stock. Hopkins, note 3 supra at 266 n. 17. The few states that permit this involve stock which has neither dividend nor liquidation rights, so the "stockholders" are closely analogous to members of a nonstock membership not-for- profit corporation. Ownership of stock is not fatal to tax-exempt status, if the stock has no right to dividends nor to receive assets upon dissolution. Rev. Rul. 68-222, 1968-1 C.B. 243, restating I.T. 3860, 1947-2 C.B. -70. (Both precedents involved title-holding companies for a 501(c)(7) fraternity.)

[10]The relevant regulations define "private shareholder or individual" as including "persons." Treas. Reg. § 1.501(a)-1(c). "Person" includes individual, trust, estate, corporation, and partnership, under § 7701(a)(1). The Service has opined that "a labor union . . . is a 'person' to whom the inurement proscription applies." G.C.M. 38322 (March 24, 1980). In G.C.M. 39414 (Sept. 25, 1985), the Service stated, "In our opinion, a section 501(c)(3) organization may not loan its funds to private individuals o£ corporations for use in a business context without violating the statutory prohibition against private inurement." (Emphasis added.) Accord. Hopkins, note 3 supra at 266 n. 21 ("[P]rivate inurement can occur where the entity being privately benefited [sic] is a person other than an individual.").

[11]Harding Hospital Inc. v. United States, 508 F.2d 1068, 1072 (6th Cir. 1974) ; Northwestern Municipal Ass'n v. United States. 99 F. 2d 460, 463 (8th Cir. 1938). In Chattanooga Automobile Club v. Commissioner. 182 F.2d 551 (6th Cir. 1950) the court invoked the inurement doctrine where an automobile club furnished to private individuals emergency road service, free tourist information and an insurance policy. The G.C.M. says that "the inurement prohibition, while stated in terms of the net earnings of an organization, applies to any of [an organization's] charitable assets."

> Distribution of earnings. An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. For the definition of the words “private shareholder or individual”, see paragraph (c) of § 1.501(a)-1.

The § 1.501(a)-1(c) definition also is of little interpretive help:

> “Private shareholder or individual” defined. The words “private shareholder or individual” in section 501 refer to persons having a personal and private interest in the activities of the organization.

No Code language deals directly with the proscription of private benefit. The regulations under § 501(c)(3) provide:

> “An organization is not organized or operated exclusively for [charitable] purposes . . . unless it serves a public rather than a 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. “[12]

As the Tax Court recently reaffirmed, “while the prohibitions against private inurement and private benefits share common and often overlapping elements, . . . the two are distinct requirements which must independently be satisfied.”[13]

There are two principal differences between the two doctrines. First, while the inurement proscription applies only to benefits received by “insiders,” the private-benefit proscription applies to benefits received by anyone, including

[12]Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). The examples at the end of the second quoted sentence might appear to restrict the private-benefit doctrine to “insiders,” but its application has not been so limited.

[13]American Campaign Academy v. Commissioner, 92 T.C. 1053, 1068 (1989) (citations omitted).

wholly disinterested persons.[14] Second, the receipt of any benefit by an "insider," no matter how trivial, is fatal,[15] whereas purely "incidental" benefits received by others will not violate the private-benefit restriction.[16] The G.C.M. adopts and restates these distinctions, stating that "[the] private benefit prohibition applies to all kinds of persons and groups, not just to those 'insiders' subject to the more strict inurement proscription." Further, "the absence of inurement does not mean the absence of private benefit. Inurement, then, may be viewed as

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[14]The G.C.M. explicitly so states. The cases also support this. See, e.g., American Campaign Academy, note 12 supra. Accord, Hopkins, note 3, supra at 266, 297-99.

[15]As the G.C.M. puts it, "inurement may be found even though the amounts involved are small. . . . There is no de minimis exception to the inurement prohibition." Nor is it a defense that the benefit received, even if added to actual compensation paid to the benefitted "insider," would be within the bounds of reasonable compensation. The G.C.M. cites, for this proposition, Founding Church of Scientology v. United States, 412 F.2d 1197, 1202 (Ct. C1. 1969), cert, denied. 397 U.S. 1009 (1970); Lowry HOSP. Ass'n v. Commissioner, 66 T.C. 850 (1976); and People of God Community v. Commissioner, 75 T.C. 127 (1980). Consistent with this view, the G.C.M., after finding inurement to the doctors, goes on to state "we need not consider . . . whether the benefit conferred on the physicians ever could be considered reasonable compensation. . . "

[16]The IRS's Audit Guidelines for Hospitals, published in Ann. 92-83, 1992-22 I.R.B. 59, contain the following succinct summary of these distinctions:

"Although the requirements for finding inurement or private benefit are similar, inurement and private benefit differ in two key respects. The first is that even a minimal amount of inurement results in disqualification for exempt status, whereas private benefit must be more than quantitatively or qualitatively incidental in order to jeopardize tax exempt status. The second is that inurement only applies to 'insiders' (individuals whose relationship with an organization offers them an opportunity to make use of the organization's income or assets for personal gain), whereas private benefit may accrue to anyone." § 333.2(2)

For general commentary on the guidelines, see Kenneth L. Levine, The New Hospital Audit Hit List: An Analysis of the Revised Tax- Exempt Hospital Audit Guidelines. 70 Taxes 399 (June 1992).

a subset of private benefit."[17]

## Legislative History

The inurement language now in § 501(c)(3) dates from the Tariff Act of 1909. It was added on the Senate floor as an amendment by Senator Augustus O. Bacon of Georgia. Prior to the amendment, the proposed bill would have taxed <u>any</u> corporation. Senator Bacon's amendment exempted certain charitable organizations from the tax. He described his amendment, in part, as follows:

> "[I]n this partial levy of tax, where we are seeking to reach a certain class of wealth, we very properly except those institutions and those enterprises which have no element of personal gain in them whatever, and which are devoted exclusively to the relief of suffering to the alleviation of our people, and to all things which commend themselves to every charitable and just impulse. . . .
>
> "[T]he corporation which I had particularly in mind as an illustration at the time I drew this amendment is the Methodist Book Concern, which has its headquarters in Nashville, which is a very large printing establishment, and in which there must necessarily be profit made, and there is a profit made exclusively for religious, benevolent, charitable, and educational purposes, in which no man receives a scintilla of individual profit. . . . [T]he amendment is very carefully guarded, so as not to include any institution where there is any individual profit, and further than that, where any of the funds are devoted to any purpose other than those

[17] It is interesting to compare Treas. Reg. § 1.892-2T(a)(2), limiting the benefits of § 892 (exempting certain income of foreign governments from tax) to amounts actually credited to the foreign government "with no portion inuring to the benefit of any private person." Treas. Reg. § l.892-2T(b) elaborates:

> "Income will be considered to inure to the benefit of private persons if such income benefits:
>
> > "(1) Private persons though the use of a governmental entity as a conduit for personal investment; or
> >
> > "(2) Private persons who divert such income from its intended use by the exertion of influence or control through means explicitly or implicitly approved of by the foreign sovereign."

> which are religious, benevolent, charitable, and educational. So, it seems to me it is doubly guarded. It is guarded so as not to include in the exemption any corporation which has joint stock or in which any individual can receive a dividend for his personal use, and it is further guarded so as not to include any corporation which assesses any part of its revenue for any purpose other than those which are mentioned — religious, benevolent, charitable, and educational."[18]

## Discussion

More than six decades after the inurement rule first appeared in the tax law, a Federal District Judge said of the inurement language, "There is very little material by way of guidance to this Court in the regulations or in any case law as to the application and meaning of that sentence. "[19] It was not until almost a decade later - in the 1980s - that the Service began to develop more precise descriptions of the inurement and private-benefit doctrines. The most helpful analyses appear in General Counsel Memoranda, and the G.C.M. is one of the clearest and most useful among them.

### I. The Meaning of "Private Shareholder or Individual".

The regulations under § 501(c)(3), quoted above, contain only the following exegesis of the private inurement language: "The words 'private shareholder or individual' in section 501 refer to persons having a personal and private interest in the activities of the organization. "[20] The G.C.M., perhaps recognizing the limited value of the regulatory words, interprets the quoted language as follows:

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[18] 44 Cong. Rec. 4150-51 (July 6, 1909).

[19] Universal Church of Scientific Truth, Inc. v. United States, 32 A.F.T.R.2d 6122, 6133, 74-1 U.S.T.C. f 9360 (N.D. Ala. 1973).

[20] Treas. Reg. § 1.501(a)-1(c).

> "The proscription against inurement generally applies to a distinct class of private interests - typically persons who, because of their particular relationship with an organization, have an opportunity to control or influence its activities."

It is clearly necessary to provide <u>some</u> boundaries to the class of "insiders." As the Tax Court has said:

> "to equate an 'insider' with potentially the whole community would so gut the insider test as to transmogrify it from a test of some precision in distinguishing private benefit to a test of such general application as to be useless."[21]

The published position of the Service that is most closely in point is more than twenty years old. In Rev. Rul. 69¬383, 1969-2 C.B. 113, the Service approved the payment of a percentage of adjusted gross revenues by a hospital to a radiologist upon a finding that the radiologist lacked control or management authority. The ruling, however, also held that the payments did not constitute unreasonable compensation, a ground which might have permitted such payments even to a "insider." It is not completely clear whether the no-control finding in Rev. Rul. 69-383 went to the status of the radiologist (i.e., that he was not an "insider") or to the reasonableness of the compensation (i.e., that the amount resulted from truly arms-length negotiations).

[21] <u>Sound Health Ass'n v. Commissioner</u>, 71 T.C. 158, 186-87 (1978). <u>Accord</u>, <u>Goldsboro Art League, Inc. v. Commissioner</u>, 75 T.C. 337, 345 (1980). In the same vein, the Service has written: "The word 'private' is the antonym of 'public' — used to distinguish a private individual from the general public — and is intended to limit the scope of those persons who personally profit from the organization to the intended beneficiaries of the allowable activities." G.C.M. 38322 (March 24, 1980).

The G.C.M. distinguished Rev. Rul. 69-383, primarily on the basis it was issued at a time when hospitals generally billed for a physician's total services and included in his total compensation only a “professional component,” retaining the “technical” or “facility” component. As noted by the G.C.M., as a result of the enactment in 1982 of changes affecting Medicare reimbursement for hospital-based payments, the typical arrangement today provides for such physicians to bill separately for their professional services, while the hospital bills separately for the technical component. The G.C.M. further notes that Rev. Rul. 69-383 “cautioned that the presence of a percentage compensation arrangement will destroy the organization's exemption where it transforms the principal activity of the organization into a joint venture between it and a group of physicians ...” and that if compensation is not reasonable, inurement will result. Perhaps the G.C.M. is implying that each individual doctor in a group of physicians acting collectively could properly be treated as a controlling person even if no individual physician acting separately would be. Both in the context of Rev. Rul. 69-383 and as a matter of practical analysis, that distinction seems a reasonable one, i.e., all other things being equal, it is easier for a group of doctors to control a hospital's policies than a single doctor.

We believe it would be improper and unwise to test for “insider” status only by looking for receipt of a benefit, no matter how substantial, without regard to the nature of the relationship between the insider and the service provider. The inurement prohibition is violated when two tests are met: (1) an “insider” is identified, and (2) the “insider” receives a prohibited benefit. The literature and precedents frequently discuss the second test, i.e., the nature of the proscribed benefit. There is very little guidance on the scope of the first test, i.e., the circumstances which give rise to “insider” status.

This lack of interpretative authority does not mean that one can ignore the regulatory requirement that a “private shareholder or individual” is a “person having a personal and private interest in the activities of the organization.” Clearly, those words do not encompass every person who benefits from an exempt organization's activities. The G.C.M. makes clear that such persons are those with “an opportunity to control the activities of the organization,” i.e., “insiders.” In some instances, “insider” status may be found by virtue of the individual's title and role vis-a-vis the charity. For example, directors, trustees, members, founders, substantial contributors, and officers are usually, and properly, deemed to be “insiders.”[22]

Employees (other than those holding positions enumerated in the preceding sentence) should also often be held to have “insider” status, but this should not be a mechanical rule. There is some language to the contrary, however, in G.C.M. 39670 (Oct. 14, 1987):

> “[I]t is our opinion that all persons performing services for an organization have a personal and private interest and therefore possess the requisite relationship necessary to find private benefit or inurement.”

[22]he IRS Exempt Organizations Handbook lists each except directors and officers. Exempt Organizations Handbook (IRM 7751) § 381.1(2). Another interesting analogy, which would support finding the enumerated persons to be “insiders,” is § 4946, defining “disqualified person” for purposes of the private foundation rules of Chapter 42. The analogy is imperfect for various reasons, however, and we would not in any event suggest that government officials per se should be treated as “insiders,” despite § 4946(a)(1)(I).

Unfortunately, the position taken in G.C.M. 39670 was explicitly restated, perhaps with approval, in the G.C.M. If, however, the issue is one of an “opportunity to control,” as stated in the G.C.M., this statement is patently incorrect. For example, a nurse or a janitor in a hospital generally would not be an “insider” within the commonly-used meaning of the word. Further, although the G.C.M. may imply that all physicians on the medical staff of a hospital are automatically “insiders,”[23] that issue should be considered in the context of whether the physician in question has any kind of control or management authority with respect to the hospital. The facts and circumstances of each case should be considered and be determinative.[24]

“Insider” status should not be limited, however, to persons holding such positions or titles. In a number of cases, again under all of the relevant facts and circumstances, independent contractors and other apparent third parties may be “insiders.” Candidates for insider status might include, for example, an attorney acting as general counsel or grants administrator for a small and otherwise-unstaffed private foundation, or a fund-raising counsel operating on a percentage-of-receipts compensation arrangement for an impoverished grant-seeking organization which lacks a vigorous and independent Board of Directors.

It is tempting, but in our view wrong, automatically to confer “insider” status on any person who receives prohibited benefits – no matter how substantial - from a charity. Such a rule would risk terminating tax-exempt status whenever a charity

[23]The G.C.M. says this follows from their “close professional working association with the hospital,” relying on G.C.M. 39498 (Jan. 28, 1986).

[24]A staff resident or other beginning physician would frequently not be an “insider.”

ends up on the wrong side of a bad bargain. Nevertheless, the G.C.M. contains some language which, if not read as applicable only to control persons, might be read to point in this erroneous direction. It states, "it is . . . clear that, if salaries or total compensation are not reasonable, they will result in inurement."[25]

In a superficially-analogous context, there is authority which might be viewed as supporting this line of reasoning. Treasury Regulations promulgated under § 482 read as follows:

> "The term 'controlled' includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted."[26]

The final quoted sentence might appear to support reasoning from the receipt of a proscribed benefit to the existence of "insider" status. For various reasons, we reject the notion that a similar concept should apply in the tax-exempt organization context.

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[25]The statement is particularly troubling because it appears towards the end of an extended discussion of Rev. Rul. 69-383, supra. which involved percentage compensation paid to a radiologist who did not (in the words of the ruling) have any "control over, or management authority with respect to, the hospital itself." Id. at 114. The statement cites to two cases for support: Mabee Petroleum Corp. v. United States, 203 F.2d 872, 876 (5th Cir. 1953), and Birmingham Business College. Inc. v. Commissioner, 276 F.2d 476, 480 (5th Cir. 1960). In both cases, the benefits in question were paid to individuals who founded, owned, and clearly controlled the alleged charitable corporation. In Mabee Petroleum, the amounts paid were held to constitute unreasonable compensation. In Birmingham Business College, the three shareholders (the founder and his two sisters, equally) had agreed that all salary payments would be proportional to their stock ownership interests. Neither authority supports an inference that the receipt of benefits, in the absence of other clear indicia of control, would suffice to confer "insider" status on the benefitted individual. Thus, it may be more reasonable to interpret the quoted language from the G.C.M. as following from an assumption or finding of "insider" status, which in turn has been established in some other manner.

[26]Treas. Reg. § 1.482-l(a) (3).

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

There is an illogical circularity in testing for “insider” status by looking for receipt of benefits. The inurement rules differ from the incidental-private-benefit doctrine precisely in not requiring a weighing of the amount of the benefit. To use the receipt of benefit, then, as a determinant of “insider” status is to eliminate the independent status of the latter doctrine: any benefit received would serve to demonstrate “insider” status, thus (a) making the finding of benefit invariably fatal to tax exemption, and (b) leaving no instance in which the incidental-private-benefit doctrine is required.[27] That is not the law.

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

## II. Implications for Financial Activities of Charities

There is broad language in the G.C.M. which may put into question the propriety of certain preferred investment and other financial activities of charities generally in contexts having nothing to do with hospital revenue sales. This Section of the Report considers the more generalized implications of the G.C.M.'s discussion with respect to the financial activities of tax-exempt entities.

### A. Permitted Investments

#### 1. Economics of Revenue Sales

In the joint venture considered in the PLRs, the hospitals sold their current anticipated net revenue streams from particular divisions or operations.[28] The hospitals received the present value of the anticipated future net earnings (apparently determined on projections based on current levels of revenue and

[27] The authors of the G.C.M. apparently did not intend this result, since the G.C.M. clearly recognizes the two doctrines as separate and distinct.

[28] The transaction considered in one of the published PLRs was a sale of the net revenue stream from certain hospital facilities. See Private Letter Ruling 8820093 (Feb. 26, 1988). The transaction considered in the other published PLR involved the sale of the gross revenue stream from certain hospital facilities subject to the joint venture's obligation to reimburse the hospital's direct and indirect costs in operating those facilities; accordingly, in essence this also entailed the sale of a net revenue stream. See Private Letter Ruling 8942099 (July 28, 1989).

expense) in exchange for the right to those earnings. The doctors bore the risk that expenses would be greater than projected (or that gross revenues would be less than projected), and that as a result actual net revenues would be less than expected. However, if actual revenues turned out to be substantially greater than the projected net revenue stream, the doctors would reap significant rewards from their investment. Stated broadly, the hospitals had a preferred-type interest providing for a limited (but relatively certain)[29] return, while the doctors had a common-type interest, at risk for the underlying investment but entitled to participate in an unlimited upside.

The doctors invested an amount based on projected performance, and obtained the benefits - and were subjected to the risks - of actual performance. The possibility that the doctors would refer patients to the hospitals and thereby increase revenues was not taken into account in the projection of future net income and, accordingly, in the price paid by the doctors for their investment. However, these expected referrals to the hospitals could be anticipated to influence actual future performance and increase the doctor's benefits. The G.C.M. does not specifically analyze the hospitals' downside protection from the arrangements in terms of the relation of the amounts received to the projected amounts of revenues and expenses. The G.C.M.

[29]Under the arrangements considered in the published PLRs, the hospitals still bore the risk (which might only be theoretical) that expenses would exceed revenues. In the published PLR involving a net revenue stream sale, the joint venture partnership agreed to make up a shortfall of revenue relative to operating costs; in the published PLR involving a gross revenue stream sale, the joint venture partnership agreed to reimburse the hospital for all applicable direct and indirect operating costs. In both cases, however, the general partner of the joint venture limited partnership was the hospital or its affiliate support organization. Consequently, unless the limited partner physicians were subject to additional contribution obligations, the hospitals, in their direct or indirect role as a general partner, were in effect required to make up any unanticipated shortfall if revenues were exceeded by expenses. As a result, the hospitals' return on these transactions can be described as only “relatively” certain.

also does not specifically analyze the upside potential for the doctors in terms of the percentage of increase in revenues required for the investment to be profitable.

2. Concerns Regarding Interests in Joint Ventures.

The G.C.M. indicates concern with the economics underlying the net revenue stream sales considered in the PLRs:

> “One of the more troubling characteristics of the arrangements at issue is the complete lack of symmetry in upside opportunities and downside risks for the physician -investors. Here, there is tremendous reward potential, but, assuming the deal co-opts potential competitors, very little downside risk. Moreover, most of the downside risk is borne by the general partners, not the physician-investors. The opportunity to invest in such a profitable venture to which the physician may be referring could itself be viewed as an illegal remuneration under the anti-kickback statute. In each of these cases, participation is limited to referral sources. As a practical matter, non-referral sources are not afforded any opportunity to invest.” (Emphasis supplied.)

The G.C.M. does not elucidate whether the Service's concern is that (1) the arrangements at issue in the PLRs are inherently inappropriate because they allow the upside in the earnings from the hospitals' tax-exempt activities to be shared by (or inure to) private individuals, (2) preferred but limited interests are inherently inappropriate holdings for charities,[30] or (3) the sharing of tax-exempt profits or holding of preferred interests, while not inherently inappropriate, are on terms in the PLRs which are not sufficiently beneficial to the hospitals. If the G.C.M.'s underlying rationale is based on the second of these possible concerns, a charity may imperil its tax exemption

[30] The GCM does not appear to imply that joint ventures are inherently inappropriate investment vehicles for tax-exempt entities. An April 29, 1992 speech to the Health Care Financial Management Association annual conference by James McGovern, Assistant Internal Revenue Service Chief Counsel (Employee Benefits and Exempt Organizations) is reported to include the specific statement that “GCM 39862 is not directed at all joint ventures ....” See BNA Daily Tax Reporter, April 30, 1992.

merely by holding a preferred interest in a corporation or investment partnership.

There is no indication that Congress intended that the holding of preferred interests, per se, should subject exempt entities to adverse tax treatment. For example, private foundations, which are subject to more restrictive rules than other charities with respect to permissible investments, are allowed to hold preferred interests, even when insiders hold common interests. In several private letter rulings under Section 4941 which imposes an excise tax on private foundations that engage in self-dealing, the Service has considered whether the redemption of a private foundation's preferred stock in a corporation that was a disqualified person on account of insiders' controlling interests constituted self-dealing. While the Service's conclusions on the self-dealing issue have turned specifically on the applicability of § 4941(d)(2)(F),[31] none of the rulings suggests that the foundation's holding of preferred stock simultaneously with the disqualified person's holding of common stock amounted to self-dealing. Similarly, Treas. Reg. § 53.4941(d)-3(d)(1), Example (2) indicates that while a disqualified person's issuance of debt to a private foundation in a preferred stock-for-debt redemption is self-dealing, neither

[31]Section 4941(d)(2)(F) states:

> "Any transaction between a private foundation and a corporation which is a disqualified person (as defined in § 4946(a)), pursuant to any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, shall not be an act of self-dealing if all of the securities of the same class as that held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value;• • •"

See, e.g.. Technical Advice Memorandum 9205001 (Sept. 12, 1991) (redemption that fails to meet § 4941(d)(2)(F) criteria constitutes self-dealing); Private Letter Ruling 9015055 (Jan. 17, 1990) (redemption not self-dealing because § 4941(d)(2)(F) applies).

the foundation's holding of preferred stock nor the redemption itself amounted to self-dealing.

Although these authorities construe only the private foundation provisions, their clear implication is that private foundations may hold preferred interests without losing their exempt status, even in a situation in which disqualified persons hold common interests. A fortiori, non-private foundations also should not lose their qualification. If the G.C.M. seeks to establish the contrary per se rule for tax-exempt hospitals, that position would be unauthorized.

The G.C.M. conforms more easily to existing authority if the Service's objections to the arrangements considered in the PLRs are viewed as turning primarily on the economics of the transactions at issue. In any event, the Service should (1) articulate with specificity which aspects of the arrangements considered in the PLRs it found problematic,[32] and (2) if the holding of certain types of preferred interests is a problem, set forth guidelines that enable charities to hold preferred interests without jeopardizing their tax exemptions.[33] At the very least, such guidance should provide that preferred

[32]The recently issued audit guidelines, Manual Transmittal 7(10)69-38 § 333.4, do not provide this specificity in discussing joint ventures which involve the sale of income streams (§ 333.4(7)). The guidelines do indicate generally a concern where “the amount of capital invested by the physician is disproportionately small and the returns on investment are disproportionately, large when compared to a typical investment in a new business venture. § 333.4(5)(g).

[33]If the Service considered the joint ventures at issue in the PLRs problematic because the returns earned by the limited partner physicians would be derived from the hospitals' tax-exempt activities, the Service should make its position explicit.

interests[34] held by tax-exempt entities in corporations or partnerships do not result per se in inurement or private benefit so long as the charity's return on its preferred interest reflects an arm's-length yield.[35] Close scrutiny of such arrangements could be mandated if insiders hold accompanying common interests. By providing that preferred interests do not necessarily lead to inurement or private benefit, such a guideline would accord with the principle that charities, other than private foundations, are permitted to make loans to insiders on arm's-length terms.[36]

B. "Kicker" Interest Payments.

The G.C.M. suggests that a tax-exempt entity's payments of interest to a third-party lender, if calculated as a function' of earnings, may threaten the charity's tax exemption:

> "It certainly is permissible for a section 501(c)(3) hospital to borrow funds against future earnings; in fact, they often use tax exempt bonds to borrow at favorable interest rates. Nevertheless, we do not believe it would be proper under most circumstances for a charitable organization to borrow funds under an agreement, even

[34]For these purposes, "preferred interests" may be defined along the lines of Treas. Reg. § 1.305-5(a):

> "The term 'preferred stock' generally refers to stock which, in relation to other classes of stock outstanding enjoys certain limited rights and privileges (generally associated with specified dividend and liquidation priorities) but does not participate in corporate growth to any significant extent. The distinguishing feature of 'preferred stock' for the purposes of section 305(b)(4) is not its privileged position as such, but that such privileged position is limited and that such stock does not participate in corporate growth to any significant extent."

[35]It is unclear whether the transactions at issue in the G.C.M. would meet this standard, since insufficient facts are stated in the PLRs to determine whether the hospitals' loss of the upside in the sold revenue streams was justified by the protection they gained against a reduction in gross revenue or an increase in expense.

[36]See § 503(b)(1); S. Rep. No. 552, 91st Cong., 1st Sess. 28¬29 (1969), reprinted in 1969-3 C.B. 423, 442-43 (removing private foundations from § 503 arm's length and self-dealing requirements and subjecting them to separate prophylactic rules under § 4941).

> with an outside commercial lender, where the organization would pay as interest a stated percentage of its earnings. See People of God Community. While doing so might not constitute inurement if an outside lender were involved (but see discussion of private benefit, below), it would if the lender were, as here, an insider."

The source of the Service's discomfort with "kicker" interest paid to outside lenders is unclear from the G.C.M.[37] The G.C.M. does not articulate whether the Service is objecting to the ultimate receipt by non-exempt lenders of a portion of the charity's "exempt" earnings through a kicker interest provision, or is merely calling attention to the need for a kicker interest provision to be at arm's-length in order to avoid undue private benefit.

Kicker interest is a standard leveraging mechanism in a wide range of investments, particularly involving real estate. Provided that the kicker provision is the product of arm's-length negotiations and particularly if there is a "cap" on kicker interest to- assure its reasonableness, we see no reason to bar charities from borrowing opportunities that commonly call for kicker interest. The Service should establish, either by ruling or regulation, that charities may undertake arm's-length kicker interest obligations that conform to industry practice. If the Service wants to establish a more stringent rule to inhibit the utilization of kicker interest to effect a sharing of a charity's "tax-exempt" earnings (as opposed to its investment income) with a lender, the Service should set out that position expressly.

## III. Need for Regulatory Guidance

The G.C.M. provides the Service's most comprehensive review of the guidelines governing a hospital's relations with

[37] Presumably, an otherwise unrelated bank lender would not be an insider.

its medical staff. The nature of the questions considered by the G.C.M. — and the importance to taxpayers of reaching the "correct" answers to these questions — demonstrate that the Service should provide taxpayers with clear advance guidance whether specific activities are proscribed or allowed. Although such guidance could be promulgated in the form of an administrative pronouncement, such as a revenue ruling or revenue procedure, we believe the regulatory approach is preferable because it permits the participation of interested parties in the rulemaking process and also because it can address these issues more comprehensively for all exempt organizations, not only hospitals.

As the G.C.M.'s analysis makes clear, the doctrines of inurement and private benefit are elusive. The conclusions drawn in the G.C.M. appear to reflect line drawings that implement policy judgments, rather than consistently applied legal principles. The inconsistent results of the G.C.M.'s analysis may be unavoidable because of the amorphous nature of the governing legal doctrines. Numerous courts have wrestled with these concepts, with varying (and at times inconsistent) results Under these circumstances, taxpayers should not be put to the peril of losing tax exemptions in concluding that their conduct does not constitute inurement or yield an undue private benefit. Nor, in this context, should taxpayers in effect be compelled to seek private letter rulings that are subject to revocation because of transactions that the Service may disapprove for other taxpayers. At the least, there should be a published framework in the context of which such, private letter rulings are issued.

Generally, agency rulemaking is governed by the Administrative Procedure Act (the "APA"). The extent of the APA's application to the issuance of Treasury Regulations is somewhat uncertain because of the broad grant of discretion in § 7805(b) and the provision in § 7805(e) for simultaneous issuance of temporary and proposed regulations. The limited judicial authority considering the application of the APA to Treasury Regulations indicates, however, that the notice and comment provisions of the APA[38] do apply to Treasury Regulations.[39] These provisions require the rulemaking agency, after giving notice, to afford interested parties an opportunity to comment on proposed non-interpretive rulings.

Courts have pointed out that the notice and comment requirement was intended to provide an opportunity for public participation in the agency rulemaking process[40], and to protect the public's right to present and exchange views, particularly at an early stage in the decisionmaking process when the agency is more likely to be receptive to alternative ideas.[41] Thus, APA-guided rulemaking is more likely than administrative action to ensure that advance Service guidelines governing hospital/doctor joint ventures take into account the concerns of taxable and tax-exempt entities. Moreover, the notice and comment process would be likely to produce for the Service a broad range of data that would enable the Service to develop effective and appropriate advance guidance.

A G.C.M. is a particularly infelicitous means of providing guidance with respect to hospital/doctor joint

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[38]5U.S.C. § § 553(b) and (c).

[39]See American Standard, Inc. v. United States, 602 F.2d 256 (Ct. C1. 1979) (regulations invalid); American Medical Ass'n. v. United States, 887 F.2d 760 (7th Cir. 1989) (regulations not invalid).

[40]National Nutritional Foods Ass'n v. Kennedy, 572 F.2d 377, 383 (2d Cir. 1978).

[41]Northern Arapahoe Trive v. Hodel, 808 F.2d 741, 751 (10th Cir. 1987).

ventures, which raise a host of policy-driven issues. Although a G. C.M. binds neither the Service nor any other party, taxpayers may ignore it only at their risk. Unlike APA-regulated rulemaking, it does not require the Service to take account of the views and experiences of relevant constituencies. In short, it is an unnecessarily parochial approach to complex legal questions. Advance clarification, whether by regulation or administrative action, would alleviate many of the uncertainties created by the Service's use of G.C.M. to provide an extended analysis of hospital/doctor joint ventures.[42]

Taxpayers are entitled to a clear code of conduct that informs them, as specifically as possible, which kinds of joint ventures are consistent with a charitable organization's tax exemption. While the inurement and undue private benefit standards should underlie such guidance, the Service should specify, perhaps by examples in the regulations, which “safe harbor” joint venture arrangements, if any, would not jeopardize

[42]On April 1, 1992, the Service issued revised hospital audit guidelines that now include new language governing examinations of hospital/doctor joint ventures. The revised audit guidelines largely track the conclusions of the G.C.M. and are phrased in fairly general terms. For example, the guidelines state, “Be alert for joint ventures involving the sale by a hospital of the gross or net revenue stream from an existing hospital service for a defined period of time to private interests.” This standard clearly does not provide an examining agent with much guidance as to which arrangements are improper, or why. The Service has apparently been applying these guidelines since October 1991. In view of the guidelines' lack of specificity and their retroactive applicability, we do not believe that they provide the type of advance guidance advocated in this report.

an organization's tax exemption.[43]

Such comprehensive guidelines are especially important for the medical industry, since it involves direct competition between taxable and tax-exempt institutions in activities that potentially qualify for tax exemption. Rules governing hospital/doctor joint ventures would have a significant impact on both types of entities. While the need for advance guidance of any sort is particularly acute in this area for the reasons discussed above, regulatory rulemaking is preferable because it would facilitate the participation of the diverse interested parties.

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[43]One example of a broad policy issue that should be addressed by regulation is inherent in the fact that although the G.C.M. treats the expansion of available medical facilities as a public benefit, it does not view maintenance or enhancement of a hospital's market share similarly. The G.C.M.'s approach appears to rest on the grounds that efforts to promote one hospital's market share would be likely to hamper the ability of other hospitals to provide public health services. Expansion of one hospital's medical facilities, however, could also limit the viability of other hospitals because potential patients would likely be less willing to be treated in hospitals that offer fewer services. The G.C.M.'s differentiation between expansion of facilities and preservation of market share seems to reflect a policy judgment regarding appropriate hospital activities, not an application of a clearly defined- notion of public benefit.