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# Summary of Existing US Law Affecting Fourth Sector Organizations

- DISCUSSION DRAFT -

July 17, 2008

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*This brief summary of the law is only a discussion draft intended to be revised during and after the Fourth Sector Legal Strategy Meeting on July 17, 2008. This draft is not intended to be an exhaustive list and only includes laws affecting Fourth Sector organizations legally structured as for-profit corporations, non-profit corporations and 501(c)(3) charities. It does not include Limited Liability Companies, foundations, partnerships, trusts, and cooperatives.*

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## A. FSOs as for-profit corporations (FP FSOs):

### i. Fiduciary Duty:

ISSUE: When will a FP FSO director breach his fiduciary duty of care, loyalty, and good faith?

RULE: Fiduciary duties are derived from state law statutes; however, most states have provisions similar to the Model Business Corporations Act (MCBA). Section 8.30(a) of the MCBA requires that "each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.

STANDARD OF REVIEW: **Business Judgment Rule (BJR):** Under the BJR, the court presumes a director is acting in best interest of shareholder and corporation in making day-to-day decisions and inquires no further.

CASE LAW:

- *Ryan v. Gifford*, 918 A.2d 341, 357 (Del. Ch. 2007);
- *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984);
- *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

### ii. Social Mission:

ISSUE: Can a FP FSO maintain its values and social purpose during and after a change of control situation (e.g.) mergers and acquisitions?

RULE: In most change of control situations, a director has a higher chance of breaching his fiduciary duty because the court applies a higher standard of review. Although the law is largely derived from case law, most states apply Delaware case law when a novel situation arises.

#### **Stakeholder v. Shareholder Primacy Doctrine:**

A Director has a duty, under most state statutes, to act in the best interests of its shareholders and the corporation. A shareholder's interest is presumed to be profit, and the best interests of a corporation assumed to be the values expressed in the corporate bylaws. Depending on the context, Delaware jurisprudence suggests courts will apply a balancing test, taking into consideration both the interests of shareholders and non-shareholders. However, decisions made in favor of stakeholders *at the expense of* shareholders will mostly likely be rejected as a violation of fiduciary duty because BOD acts as trustees and must respect the financial interests of the

shareholders.

**STANDARD OF REVIEW: Revlon Standard (Delaware):** The Delaware courts apply the *Revlon* standard “when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear breakup of the company;” or “where a target abandons its long-term strategy and seeks an alternative transaction involving the breakup of the company”. Under this strict standard of review, a director must sell to the highest bidder or implement routine defensive strategy to enable the board to negotiate for a higher bid on if “However, *Revlon* still “permits consideration of other constituencies so long as it is “rationally related [to] benefits accruing to the stockholders.” *Revlon, Inc. v. Macandrews & Forbes Holdings*, 506 A.2d 173, 185 (Del. 1986) (citing *Smith v. Van Gorkom*, Del. Supr., 488 A.2d 858, 874 (1985)).

MOREOVER, in *Paramount v. Time* the Delaware court allowed Time to accept Warner’s lower bid instead of Paramount in a merger deal under the rationale that unlike Paramount, Warner’s culture would not threaten the “culture” of Time. *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (1990).

**Unocal standard (Delaware):** The Delaware courts apply the *Unocal* standard in a defensive takeover context. Under the *Unocal* standard, the court will give directors the benefit of the business judgment rule *only if* they can first demonstrate that they had “reasonable grounds for believing a danger to corporate policy and effectiveness existed” *and* the defensive measure was “reasonable in relation to the threat posed”. A “reasonable” decision for a defensive measure is “an element of balance” between, *inter alia*, the impact of non-shareholder constituencies, affect on shareholder value, and its effect on the corporation. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

CASE LAW: Revlon Standard:

- *Revlon, Inc. v. Macandrews & Forbes Holdings*, 506 A.2d 173, 185 (Del. 1986);
- *Smith v. Van Gorkom*, Del. Supr., 488 A.2d 858, 874 (1985));
- *Bennett v. Propp*, Del. Supr., 41 Del. Ch. 14, 187 A.2d 405, 409 (1962);
- *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (1990).

Unocal Standard

- *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964) (allowing a directors' defense against hostile takeover that would be harmful to employees);
- *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985)).

iii. Philanthropic donations:

ISSUE: I. May a FP FSO donate more than ten percent of its profit without the court finding the decision amounts to a valid corporate action; and

II. Will it receive a tax deduction on such a donation?

RULE: I. Twenty-four states, Delaware and the District of Columbia included, contain provisions that allow corporations "to make donations for the public welfare or for charitable, scientific or educational purposes." Nineteen other states, two provisions govern corporate contributions. One authorizes contributions "furthering the business and affairs of the corporation." The other authorizes truly philanthropic contributions, as it contains no such limiting language and thus identical to the laws which simply authorize donations for charitable, scientific and educational purposes. Seven other states, including CA, NY and NJ, have enacted laws authorizing corporations to make charitable contributions "irrespective of corporate benefit." *Smith Manufacturing Co. v. Barlow* (upholding the validity of Smith corporations' \$1,500 contribution to Princeton University finding the expectation of "corporate citizenship.") Further, the MBCA sec. 4 permits corporations to "make donations for the public welfare or for charitable, scientific or educational purposes."

Under Delaware law, reasonable donations do not amount to corporate waste. The Delaware court defines “reasonable” using the definition found in the Internal Revenue Code, pertaining to charitable gifts.

Note that public companies are not required under the federal securities regulations and the Securities Exchange Commission (“SEC”) to disclose whether they made a charitable donations and how much was donated.

- II. Under IRS section 170, tax deduction for corporate donations is expressly limited to ten percent. FP FSO’s may pay charities for goods and services they provide, and such payments are normally deductible as a business expense, but the charitable donation allowance is strictly limited.

STANDARD OF REVIEW: The court applies the *Theodora Holding* reasonableness standard of review to philanthropic corporate action. Under the reasonableness standard, the gift should be reasonable in both amount and purpose.

- CASE LAW:
- *Kahn v. Sullivan*, 594 A.2d 48 (1991);
  - *Theodora Holding Corp. v. Henderson*, Del. Ch., 257 A.2d 398 (1969);
  - *Sullivan v. Hammer*, No. CIV.A.10823, 1990 WL 114223 (Del. Ch. Aug. 14, 1990);
  - *A. P. Smith Mfg. Co. v. Barlow*, 98 A.2d 681, appeal dismissed, 346 U.S. 861;
  - *Union Pacific R.R. v. Trustees, Inc.*, 8 Utah 2d 101, 329 P.2d 398.

iv. Pursuit of a non-profit purpose:

ISSUE: Is a FP FSO allowed to pursue a non-profit business purpose and lawful business purpose simultaneously.

RULE: Possibly. The law varies depending on the corporate statutes within each state. The majority of states allow a business to be formed for “any lawful purpose”, or “any lawful activity” thereby allowing the pursuit of both a business and social purpose. Nevertheless, more than twelve states, New York included, require a business to purpose a “lawful business purpose” thereby prohibiting a corporation to pursue a non-profit purpose.

STANDARD OF REVIEW: The jurisprudence of each state applies and interprets what constitutes a “business” or “lawful purpose.”

CASE LAW: Refer to each state’s jurisprudence for guidance.

## **B. FSO’s as Non-profit organizations (NP FSOs): *Including mutual non-profits***

### *i. Operations for Profit:*

ISSUE: Whether a NP FSO may pursue a social and a business purpose simultaneously.

RULE: Yes. Most state non-profit statutes allow the pursuit of both a business and a social or charitable purpose. Each state has its own classification system for a non-profit corporation (NPC). Section 3.01(a) of the Revised Model Nonprofit Corporations Act (RMNCA) allows the pursuit of any “lawful activity unless a more limited purpose is set forth in the articles of incorporation.”

Under the private inurement doctrine, a NPC may earn a profit, but it is prohibited from distributing those earnings to directors, officers, members or any other interested private party. In particular, a NPC may conduct business activities, the profits from which are taxable if substantially unrelated to the organization's exempt purpose.

STANDARD OF REVIEW: Determination of whether the purpose is permissible is based on the definition of acceptable non-profit purposes under the applicable state statute.

CASE LAW: Most case law involves a NPC which is also tax exempt under section 501(c)(3) of the Internal Revenue Code. *See infra*, Section C(ii).

### *ii. Fiduciary Duties:*

ISSUE: When will a NP FSO director breach the fiduciary duty of care, loyalty and good faith.

RULE: Section 8.30(a) of the RMNCA states that “a director shall discharge his or her duties as a director, including his or her duties as a member of a committee: (1) in good faith; (2) with the care an ordinarily prudent person in

a like position would exercise under similar circumstances; and (3) in a manner the director reasonably believes to be in the best interests of the corporation. If a director breaches his fiduciary duty, directors, voting members, and in some situations, patrons and beneficiaries of the NPC may bring a derivative suit against the director on behalf of the corporation. State Attorneys General also have statutory rights to enforce fiduciary duties on behalf of the public.

Section 8.3(a) prohibits conflict of interest transactions, but allows a director to cleanse such transaction through approval in advance “by the vote of a disinterested and fully-informed board of directors or a committee of the board and...the directors approving the transaction in good faith reasonably believe that the transaction is fair to the corporation; or...[by the] approval of the attorney general.” If a director engages in self-dealing transactions that have not been ratified by disinterested directors or that are unfair to the corporation, he or she will breach his or her fiduciary duty of loyalty.

STANDARD OF REVIEW: The same SOR is applicable to both a for-profit corporation and a non-profit corporation. *See* Section A: Fiduciary Duties, *supra*. The RMNCA applies a strict, “arms-length” standard which is stricter than the standard applied in most states.

CASE LAW: There is relatively no case law. I could only find one case on this issue:

- *Mary v. Lupin Found.*, 609 So. 2d 184, 191 (La. 1992) (allowing director to bring derivative suit against co-directors for breach of fiduciary duty).

iii. Nondistribution constraint:

ISSUE: Is a NP FSO permitted to distribute profit?

RULE: Depends. A NPC can make “profits” but it can’t distribute them. Under section 13.01 of the RMNCA, a NP FSO is prohibited from making distributions to any of its members with two exceptions:

- 1) a mutual benefit corporation may purchase its memberships and after the purchase is completed: (a) the corporation would be able to pay its debts as they become due in the usual course of its activities; and (b) the corporation's total assets would at least equal the sum of its total liabilities. Sec. 13.02(a); OR
- 2) the NPC may make distributions upon dissolution. Sec. 13.02(b).

State laws governing NPC’s only bar the insiders from receiving distributions of the organization's profits. Modern non-profit statutes apply

the liberal business corporation rules to directors.

Section 501(c)(3) of the Internal Revenue Code prohibits “excess benefit” transactions, in which a charity pays more for goods and services than they are worth. “Inurement”, which involves payments to insiders not justified by a quid pro quo, or as reasonable compensation for services rendered, is also prohibited by Section 501(c)(3) of the Internal revenue Code.

STANDARD OF REVIEW: The RMNCA looks to the Internal Revenue Code (IRC) to determine the rules governing distribution of assets to insiders, to those providing goods or services to the charity, or upon dissolution. *See infra*, Section C.

CASE LAW: Refer to each state’s jurisprudence for guidance.

### C. FSO’s as 501(c)(3) entities (C3 FSO)

#### i. Fiduciary Duties:

ISSUE: Does a C3 FSO trustee have a fiduciary duty to maximize shareholder profit?

RULE: No. Both a charitable trustee and a non-profit director owe a fiduciary duty of loyalty and care to the organization but not to any shareholders. The main distinction between charities and non-profit corporations is that non-profit organizations are a creation of state law where as a tax-exempt charity is determined by federal law.

The US Supreme Court has upheld tax-exemption for charitable organizations "based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burdens which would otherwise have to be met by appropriations from other public funds, and by the benefits resulting from the promotion of the general welfare." *Bob Jones Univ. v. U.S.*, 461 U.S. 574, 590 (1983) (quoting Congressional hearings in the enactment of Revenue Act of 1938. H.R. Rep. 75-1860, at 19 (1938)).

STANDARD OF REVIEW: The IRS code and revenue rulings are referred to in order to interpret federal law.

CASE LAW: Again, very little case law on the topic of fiduciary duties of directors of charities.

- *Mary Grace Blasko et al., Standing to Sue in the Charitable Sector*, 28 U.S.F. L. Rev. 37, 53-59(1993).



ii. Operations for profit:

ISSUE: May a C3 FSO pursue an exempt and commercial purpose?

RULE: Yes. According the IRC, a C3 FSO must be organized (“**organizational test**”) and operated (“**operational test**”) exclusively for charitable and exempt purposes ( acceptable purposes also include religious, educational, scientific, literary, or to stop animal cruelty.) A C3 FSO that are organized for both exempt and nonexempt purposes fail to satisfy the organizational test and thus, will not be granted 501c3 status. *See* Rev. Rul. 69-256 169-1 C.B. 151; *see also* Rev. Rul 69-279 1969-1 C.B. 152. ). HOWEVER, a C3 that is organized for an exempt purpose may still pursue a business purpose as long as the activities generating revenue *substantially* further or accomplish an exempt purpose. *See Bethel Conservative Mennonite Church v. Comm’r*, 80 T.C. 352 (1983); *see also* Aid to Artisans, Inc. v. Comm’r, 71 T.C. 202, 211 (1978).

The **operational test** is satisfied when the actual operation of entity proves that it is primarily engaged in only exempt functions and that company serves only a “public function” and not a “private function”. In other words, if the corporation operates to further an exempt purpose, but *substantially* engages in another activity with a commercial purpose, be ineligible for tax-exemption. Engaging in *insubstantial* commercial activity is permitted, but it may result in unrelated business income tax (UBIT). *See* Federation Pharmacy v. Comm’r, 72 T.C. 687 (1979) (denying tax-exempt status to a nonprofit corporation organized to provide prescription drugs at discount prices to the elderly and handicapped because it failed the operational test. The U.S. Tax Court reasoned that it could not differentiate it from any other for-profit drugstore and it substantially engaged in activity with a commercial purpose thus rendering it ineligible for tax-exempt status. The fact that the drugs were discounted did not remove the "commercial taint.")

The **organizational test** is fulfilled only if:

- 1) company’s articles state that the purpose of the entity is limited to furtherance of its stated exempt purpose, prohibiting the organization from engaging in activities that do not further some exempt purpose ; AND
- 2) articles do not expressly empower organization to engage, otherwise that as an insubstantial part of its activities, in matters that are not in furtherance of its exempt activities; AND
- 3) upon dissolution, its assets are distributed to an exempt entity.

*See* Bruce R. Hopkins, THE LAW OF TAX-EXEMPT ORGANIZATIONS 55.

**Substantial v. insubstantial:** Modern courts consider competition with commercial firms as “strong evidence of a substantial nonexempt purpose.” *Living Faith, Inc. v. Comm’r*, 60 T.C.M. 710, 713 (1990). Although the tax court has held that the definition of insubstantial is fact specific, it has found that less than ten percent of a charity’s total efforts is “insubstantial”, *World Family Corp. v. Comm’r*, 78 T.C. 921 (1982), where as unrelated business activity generating one-third of an organizations revenue does not qualify for tax-exempt status. *Orange County Agric. Soc’y, Inc. v. Comm’r*, 55 T.C.M. 1602, 1604 (1988), *aff’d* 893 F.2d 647 (2d Cir. 1990). However, this may be changing after an increasing emphasis on commensurate test.

**STANDARD OF REVIEW:** **Primary Purpose test:** nonexempt activity will not result in loss or denial of exemption where it is “only incidental and less than substantial” and that a “slight and comparatively unimportant deviation from the narrow furrow of tax approved activity is not fatal.” Rev. Rul. 77-366, 1977-2 C.B. 192.

**Commerciality Doctrine:** In order to determine what constitutes a nonexempt commercial activity, the court applies the “commerciality doctrine.” Under this doctrine, a modern court will look to the following nine factors to decide whether an activity is commercial: whether the organization 1) sells goods and services to the public (this alone was said to make operations “presumptively commercial”) 2) is in “direct competition” with for-profit restaurants and food stores, 3) sets prices that are based on pricing formulas common in the retail food business (not “below-cost pricing”) 4) utilizes promotional materials and “commercial catch phrases” to enhance sales, 5) advertises its services and food over an extended period of time, 6) has hours of operation similar to a for-profit enterprise, 7) is governed by guidelines that require its management to have “business ability” and six months training 8) does not utilize volunteers but paid salaries and 9) does not receive charitable contributions. *See Living Faith, Inc. v. Commissioner*, 950 F.2d 365 (7th Cir. 1991), *aff’d*, 60 T.C. Mem. (CCH) 710 (1990).

- CASE LAW/ RULINGS:**
- *Plumstead Theatre Society, Inc., v. Commissioner of Internal Revenue*, 675 F.2d 244 (9th Cir. 1982) (finding that a joint venture between a C3 and FP is allowed as long as the venture has a substantial exempt purpose and the C3 has sufficient control over venture);
  - *Bethel Conservative Mennonite Church v. Comm’r*, 80 T.C. 352 (1983).
  - Priv. Ltr. Rul. 8442064;
  - *Saint Germain Found. v. Comm’r*, 26 T.C. 648 (1956);
  - *Aid to Artisans, Inc. v. Comm’r*, 71 T.C. 202, 211 (1978);

- *Federation Pharmacy v. Comm'r*, 72 T.C. 687 (1979)
- *Monterey Public Parking Corp. v. U.S.*, 321 F. Supp. 972 (N.D. Cal. 1970), *aff'd*, 481 F.2d 175 (9th Cir. 1973).
- *Living Faith, Inc. v. Commissioner*, 950 F.2d 365 (7th Cir. 1991), *aff'd*, 60 T.C. Mem. (CCH) 710 (1990).

iii. Public v. private benefit :

ISSUE: Is a C3 FSO allowed to inure to the benefit of private individuals?

RULE: According to Treasury Regulation 1-501(c)(3)-1(d)(1)(ii), "[a]n organization is not organized or operated exclusively for [exempt purposes] unless it serves a public rather than a private interest."

*See also Am. Campaign Acad. v. Comm'r*, 92 T.C. at 1053.

Essentially, a C3 must be organized and operated so that "no part of...[its] net earnings...inures to the benefit of any private shareholder, or individual." Although it is rare, the law in a few states allows a nonprofit organization to issue stock; however, this type of stock does not carry with it rights to dividends so as to not be in conflict with the private inurement doctrine. In other words, any inurement to "insiders" may result in a loss in exemption. An insider is a person who has a unique relationship with the C3, by which that person can cause application of the C3's funds or assets for the private purposes of the person by reason of the person's exercise of control over the organization. *American Campaign Academy v. Comm'r*, 92 T.C. 1053 (1989); *see also Variety Club Tent No. 6 Charities, Inc. v. Comm'r*, 74 T.C.M. 1485, 1492 (1997). Federal tax law appropriates the term insider from federal securities laws.

Net earnings are defined as gross earnings minus related expenses. *See Bank of Commerce & Trust Co. v. Senter*, S.W. 144, 151 (sup. Ct. Tenn. 1924).

Common examples of private inurement include excessive compensation, sale of assets, property, lending of money, use of facilities or other assets, retained reversionary interest and involvement in partnerships or other joint ventures.

Nevertheless, private benefit may be allowed if the benefit is:

1) unavoidable in achieving exempt purposes (and "qualitatively incidental"); and 2) not substantial as compared to overall public benefit ("quantitatively incidental").

STANDARD OF REVIEW: The reasonableness standard applies to compensation for services rendered. Under the reasonableness standard, the payment of excessive compensation can result in a finding of private inurement. *See Harding Hospital, Inc. v. U.S.*, 505 F.2d 1068 (6th Cir. 1974); *Birmingham Business College, Inc. v. Comm'r*, 276 F.2d 476 (5th Cir.1960); *Maybe Petroleum Corp v. U.S.*, 203 F.2d 872 (5th Cir. 1953); *Texas Trade School v. Comm'r*, 30 T.C. 642 (1958) *aff'd* 272 F.2d 168 (5<sup>th</sup> Cir. 1959); *Northern Illinois College of Optometry v. Comm'r*, 2 T.C.M. 664 (1943). According to the business expense regulations and intermediate sanctions regulations in the federal tax law, reasonable compensation is that amount as would ordinarily be paid for like services by like enterprises under like circumstances. *See* Reg sec.1.162-7(b)(3), Reg.sec. 53.4958-4(b)(1)(ii)(A). Unlike cases involving for-profit corporations which use the independent investor test, courts will most likely use a multi-factor test to determine what is reasonable for a tax-exempt organization, the factors of which will vary depending on the court. *See Label/Graphics, Inc. v. Comm'r* 2002-2 U.S.T.C para. 60, 648 (9th Cir. 1998).

- CASE LAW/ RULINGS:
- Rev. Rul. 98-15 (holding that the benefit of private interests of a FP member in a joint venture with a NP is permissible only if benefit is incidental).
  - *St. David's Health Care System v. US*, 349 F.3d 232 (2003)
  - *American Campaign Academy v. Comm'r*, 92 T.C. 1053 (1989);
  - *Variety Club Tent No. 6 Charities, Inc. v. Comm'r*, 74 T.C.M. 1485, 1492 (1997).
  - *Bank of Commerce & Trust Co. v. Senter*, S.W. 144, 151 (sup. Ct. Tenn. 1924).
  - *Housing Pioneers, Inc. v. Comm'r*, 65 T.C.M. (CCH) 2191 (1993), *aff'd*, 58 F.3d 401 (9th Cir. 1995).

iv. Invested/earned v. donated income

ISSUE: May a C3 FSO use its income for any lawful activity?

RULE: **Earned Income:** Generally speaking, a C3 FSO may generate a profit from services rendered, and may enter into joint ventures or contracts with for-profit entities as long as they substantially further the exempt purpose and do not constitute a substantial part of the entity's activities. Financial expansion and success experienced by a non-profit organization does not lead to revocation of tax-exempt status as long as that organization remains true to

its stated goals. As a federal court of appeals states, “the inquiry must remain that of determining the purpose to which the increased business activity is directed.” *Presbyterian & Reformed Publishing Co. v. Comm’r*, 743 F.2d 148 (3rd Cir. 1984).

**UBIT:** Nevertheless, if the income is generated from an activity unrelated to the exempt purpose, the organization may lose its C3 status, or may be required to pay an Unrelated Business Income Tax (UBIT) which is taxed at the prevailing corporate rate according to section 511 of the IRC. In *U.S. v. American Bar Endowment*, 477 U.S. 105 (1986), the US Supreme Court held that the “undisputed purpose of the UBIT was to prevent tax-exempt organizations from competing unfairly with business whose earnings were taxed.” Appropriately, the court looks to three factors to determine whether the activity is UBI. An activity generates UBI if it (i) is a “trade or business;” (ii) is “regularly carried on;” and (iii) the activity is not “substantially related” to the organization’s exempt purpose.

**EXCEPTIONS to UBIT:** The IRC provides specific exceptions to UBIT, such as selling donated merchandise, distribution of low cost items, the exchange of member mailing lists, as well as rent and royalties. To qualify for this exception, nonprofit organizations must make sure that any benefits provided to volunteers are de minimis. See, e.g., *I.R.C. §§ 513(a)(3), 513(h)(1)(A), 513(h)(1)(B)*, respectively. See also *Rev. Rul. 56-152, 1956-1 C.B. 56*

C3’s may form partnerships, invest in for-profit stock to generate passive income, or enter into contracts, with private parties to further charitable purposes on mutually beneficial terms “so long as the non-profit organization does not thereby impermissibly serve private interests.” *Redlands Surgical series v. Commissioner* 114 T.C. 47 (1999) aff’d 242 F.3d 904 (9th Cir. 2001). Nevertheless, as soon as it enters into a joint venture with a for-profit, the C3 FSO must control the venture and the income must not be a substantial part of its activities.

Modern courts have been more willing to conclude that an exempt organization’s financial undertaking does not rise to the level of a business just because they generate a profit. See *Laborer’s Int’l Union of North America v. Com’r*, 82 T.C.M. 158 (2001)

In 1987, Congress required exempt organizations to make their exemption application and annual information returns available for inspection at their places of business. See *I.R.C. 6104* (1996), see also *I.R.C. 6104(e)* (1996), as amended by Taxpayer Bill of Rights II, Pub. L. No. 104-168, 1313(a), 110 Stat. 1452 (1996). The new law takes effect only upon the issuance of regulations.

**Donated income:** Income generated from donations comes in two main

forms: those with certain restrictions on how a C3 may use the donation, and those without restrictions. When a C3 director decides to use donated income for a business venture in violation of a donor-imposed restriction, a donor may be able to bring suit for fraud or corporate waste as well as breach of contract. However, the restriction must be unambiguous for the donor to have standing.

STANDARD OF REVIEW: When C3 directors decide to use donated income or earned income for profit, state courts apply the BJR to that decision. As long as the funds that are used for the venture are not restricted to another use.

CASE LAW/ RULINGS:

- *Presbyterian & Reformed Publishing Co. v. Comm'r*, 743 F.2d 148 (3rd Cir. 1984);
- *U.S. v. American Bar Endowment*, 477 U.S. 105, 114 (1986);
- *Laborer's Int'l Union of North America v. Comm'r*, 82 T.C.M. 158 (2001);
- *Rev. Rul. 56-152, 1956-1 C.B. 56.*

v. Debt v. Equity Investment:

ISSUE: May a C3 FSO accept investments?

RULE: Depends. A C3 may incur debt to purchase an asset at its fair market value and retire the debt with its receipts without violating the private inurement doctrine. *See e.g. Shiffman v. Comm'r*, 32 T.C. 1073 (1959); *Estate of Howes v. Comm'r*, 30 T.C. 909 (1958), *aff'd sub nom, Comm'r v. Johnson*, 267 F.2d 382 (1st Cir. 1959); *Ohio Furnace Co., Inc. v. Comm'r*, 25 T.C. 179 (1955), *app. dis.* (6th Cir. 1956). Although a C3 may accept debt investments, it is prohibited from accepting equity investments. The most blatant form of private inurement stems from equity distribution to members or the board of directors. Return from a C3 is permitted as a debt investment as long as the C3 repays an investor on terms and at a fixed rate. Equity investments are prohibited because a C3 is not allowed to have shareholders who have a claim on the profits. *See Maynard Hospital Inc. v. Comm'r*, 52 T.C. 1006, 1027, 1032 (1969).

STANDARD OF REVIEW: The court applies the excessive and reasonable tests to determine whether the terms under which an asset is acquired from an insider or transferred to an insider are excessive or unfair, thereby violating the prohibition against private inurement.

CASE LAW/ RULINGS:

- *Shiffman v. Comm'r*, 32 T.C. 1073 (1959);

- *Estate of Howes v. Comm’r*, 30 T.C. 909 (1958), *aff’d sub nom, Comm’r v. Johnson*, 267 F.2d 382 (1st Cir. 1959);
- *Ohio Furnace Co., Inc. v. Comm’r*, 25 T.C. 179 (1955), *app. dis.* (6th Cir. 1956);
- *Maynard Hospital Inc. v. Comm’r*, 52 T.C. 1006, 1027, 1032 (1969);
- *Hancock Academy of Savannah, Inc. v. Comm’r*, 69 T.C. 488 (1977).