Bond Case Briefs

Municipal Finance Law Since 1971

IRS: Organization's Exemption Jeopardized by Reimbursement Payments.

The IRS ruled that the tax-exempt status of an organization providing environmental cleanup services will be affected by payments the organization makes to a company under a reimbursement agreement and that the reimbursement payments inure to the benefit of the company.

Dear * * *

We have considered your ruling request dated February 11, 2011, on the federal income tax consequences of a proposed agreement between you and Company.

FACTS

You are exempt under § 501(c)(4) of the Internal Revenue Code ("Code") as an organization that promotes the public welfare by mitigating environmental damage. Your sole member is Parent, a business league that is organized and operated to further the interests of Industry and is exempt under § 501(c)(6).

The relationship between you and members of Parent with respect to your provision of cleanup services, such as Company, is governed by a standard service agreement (SSA). The SSA provides generally that you will provide cleanup services at designated rates, and that a member of Parent, such as Company, will reimburse you for your out-of-pocket expenses and pay a mark-up equal to 10-percent of all third-party service provider charges. The 10-percent markup provision is intended to compensate you for the costs and risks associated with the management and oversight of third-party contractors assisting in the cleanup response.

In this case, Company was responsible for the Incident. You have some of your own equipment, which you keep on call for cleanups. The scale of the Incident, however, was beyond your equipment capacity. Accordingly, and in compliance with the SSA, you hired third party contractors to help with the cleanup. The 10-percent markup resulted in an obligation for Company of approximately x1 dollars.

Company initiated the request for a reconsideration of the 10-percent markup amount because it felt that the size of the Incident and the resulting sizeable 10-percent markup amount produced an unexpected "windfall" to you. After considering the request, you and Company entered into the Agreement on Date and presented it to the board of Parent.

Parent, in the interest of preserving your tax-exempt status, agreed that it was appropriate for you to negotiate the Agreement with Company, but made the receipt of a favorable letter ruling from the Internal Revenue Service (IRS) a condition of Parent's accepting the Agreement between you and Company.

The Agreement calls for the creation of a fund. You agreed to place in the fund 75 percent of the dollar amount resulting from the 10-percent mark-up assessed with respect to any charges related to

the Incident where you invoiced and Company paid a 10-percent markup. Under the Agreement, you are entitled to keep 25 percent of the amounts received from the 10-percent markup paid by Company. The remaining 75 percent placed in the fund may be used by you and Company for specified expenses related to the Incident. Many of the Agreement provisions provide for reimbursement of Company by you from the fund. Once all qualifying expenses are paid from the fund, the remainder, if any, is to be released to you.

Specifically, the Agreement provides, in part, that:

1. Company will be reimbursed from the fund for costs it incurs in auditing third-party contractors who performed work in the cleanup of the Incident. The SSA is silent on who is responsible for paying for such auditing costs, but the standard Contractor Services Agreement (CSA) you use when engaging third-party contractors provides that you have the right to access contractors' books and records to audit them at your expense.

2. You will be reimbursed from the fund for costs you incur in auditing third-party contractors if Company directs you to do so. As noted above, the CSA provides that you would normally be responsible for paying for such costs. However, under the SSA or CSA, you would audit third-party contractors in your own discretion and Company would not have the power to direct you to audit such contractors.

3. Reimbursements for audit costs in (1) and (2) are capped at x3 percent of the original amount in the fund, approximately x4 dollars.

4. Company will be reimbursed for collections costs in pursuing collections of incorrect billings from third-party contractors. You state that, under the CSA, you would be liable to pay for collections expenses for any overcharges made by contractors discovered through your audits of contractors.

5. You will be reimbursed for collection costs you incur in pursuing collections of incorrect billings from third-party contractors. Under the CSA, you would normally be liable for paying collections expenses.

6. Reimbursements for collection costs in (3) and (4) are capped at the lesser of x5 percent of the amounts collected or x6 percent of the original amount in the fund.

7. Company will be reimbursed for any incorrect billing amounts it identifies but are otherwise not recoverable, in addition to the 10-percent markup on such amounts.

8. Company will be reimbursed for the 10-percent markup on any incorrect billing amounts Company recovers.

9. You will be reimbursed for costs related to certain personal injury claims, to the extent they are not covered by the SSA, payable by insurance, or payable by a third party.

10. You and Company waive the right to challenge the validity of contracts that do not conform to the provisions of the SSA, but were entered in good faith.

Company is represented on the board of Parent by Director, who is employed by Affiliate, an affiliate of Company. You state that Director, while present for, and participating in discussions relating to the original intention underlying the 10-percent markup, the unexpected magnitude of contractor billings on which the 10-percent markup was based in the case of the Incident, and the disproportionate gross revenues produced by the 10-percent markup compared with the extra costs borne by you in connection with managing contractors engaged to assist with the Incident, did not

“participate in the final deliberations or decision” by Parent to approve your negotiations with Company. You further state that “the Parent Board’s decision was made consistent with the exercise of the remaining board members’ fiduciary duties, based solely on the best interests of Parent and its sole grantee, [you].”

You maintain that the reconsideration of the amount that Company owes you under the SSA is consistent with the original intent of the 10-percent markup, which was to cover management and oversight costs of third-party contractors. You state that the actual management and oversight expenses related to the Incident are much lower and are estimated to total approximately x2 dollars. You also state that the exchange under the Agreement between you and Company reflects the “give and take” of negotiations. Further, you state that, had Company not been a member of Parent, you would have been equally receptive to renegotiating the 10-percent markup liability, given the unanticipated size of that liability under the unique facts and circumstances presented by the Incident, and the limitations on liability and other concessions you received from Company under the Agreement.

To date, you have responded to a total of x7 calls for cleanup services, including the Incident. You have never before discounted any of the rates you charged for cleanup. You state that Company’s status as a member of Parent does not affect the reconsideration agreement, and that you would have been willing to make such an agreement as the Agreement for any other organization contracting with you. You also state that you do not intend to modify the existing service agreement with Company or any other entity. You cite the unprecedented size and financial impact of the Incident, which produced a “windfall” for you, as the reasons you were willing to negotiate with Company.

RULINGS REQUESTED

You requested the following ruling:

Payments made to Company pursuant to the Agreement will not adversely affect your tax-exempt status and will not result in inurement or impermissible private benefit directly or indirectly to Company by you.

LAW

Section 501(c)(4) of the Code exempts from federal income tax organizations operated exclusively for the promotion of social welfare, provided that no part of the net earnings of such an organization inures to the benefit of any private shareholder or individual.

Section 1.501(c)(4)-1(a)(2)(i) of the Treasury Regulations (“regulations”) provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community.

Rev. Rul. 69-383, 1969-2 C.B. 113, holds that an agreement for fixed-percentage compensation of a radiologist does not result in inurement when the agreement results from arm’s-length negotiation and the radiologist has no control over, or management authority with respect to, the hospital.

Rev. Rul. 79-316, 1979-2 C.B. 228, holds that a nonprofit organization whose purpose is to prevent liquid spills within a city port area and to develop a program for the containment and cleanup of liquid spills that occur is entitled to exemption as a social welfare organization under § 501(c)(4), provided that its services are equally available to members and nonmembers and both members and nonmembers are charged on the same basis for cleanup services rendered.

Contracting Plumbers Cooperative Restoration Corp. v. United States, 488 F.2d 684 (2d Cir. 1973), holds that an organization that repairs damage to city streets in the course of plumbing activities does not promote the common good, although its activities benefit the community, because its services are available only to repair damages caused by members.

Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974), holds that "net earnings" is a broader term than net profits according to financial statements. If a particular individual or limited number of individuals reaps commercial benefits from the operation of the instrumentality, though they do not do so by direct acquisition or payment over to them of its earnings, the earnings may nevertheless inure to their benefit.

United Cancer Council, Inc. v. Comm'r., 165 F.3d 1173 (7th Cir. 1999), holds that the inurement prohibition requires an organization not to siphon its earnings to its founder, or the members of its board or their families, or anyone else fairly to be described as an insider, that is, as the equivalent of an owner or manager. The test is functional. It looks to the reality of control rather than to the insider's place in a formal organizational chart of an organization. The insider could be a mere employee or even a nominal outsider, such as a physician with hospital privileges in a charitable hospital.

The prohibition on inurement denies exempt status to an organization whose founders or controlling members have a personal stake in that organization's receipts. People of God Community v. Comm'r., 75 T.C. 127 (1980).

The term "net earnings" may include refreshments, goods, and services furnished to members of an exempt organization. Spokane Motorcycle Club v. United States, 222 F. Supp. 151 (E.D. Wash. 1963).

ANALYSIS

Section 501(c)(4) exempts from federal income tax organizations operated exclusively for the promotion of social welfare. An organization is operated exclusively for the promotion of social welfare it is if primarily engaged in promoting in some way the common good and general welfare of the community. Treas. Reg. § 1.501(c)(4)-2(a)(i).

Revenue Ruling 79-316, 1979-2 C.B. 228, holds that preventing and cleaning up liquid spills that endanger marine life and befoul recreational beaches and shorefront property are activities designed to benefit all inhabitants of the community served by an organization. Furthermore, such an organization is exempt under section 501(c)(4), provided that its services are equally available to members and nonmembers and both members and nonmembers are charged on the same basis for the cleanup services rendered. Similarly, Rev. Rul. 66-221, 1966-2 C.B. 220, holds that an organization engaged in fighting fires and related activities promotes the common good and general welfare of the people of the community as a whole. However, services provided by an organization exclusively, or at a preferential price, to its contributors or members do not promote the common good or general welfare even though they may incidentally benefit a community. See Contracting Plumbers Cooperative Restoration Corp. v. United States, 468 F.2d 684 (2d Cir. 1973) (holding that an organization that repaired damage to city streets caused in the course of plumbing activities did not promote the common good, even though its activities benefited the community, because its activities were available only to repair damage caused by its members).

Your historical purpose and operations are consistent with these authorities regarding exemption under § 501(c)(4). However, the Agreement will change the basis upon which members and nonmembers of Parent are charged. You generally have charged members and nonmembers on the

same basis. The Agreement, however, changes the basis upon which you charge a particular member, Company, thus providing a member a better price than nonmembers.

Under the Agreement, you will reimburse Company for audit costs for which you would normally be liable under the SSA and CSA. As a result of auditing third-party contractors, Company will be reimbursed for any incorrect billing amounts it identifies, in addition to the associated 10-percent markup for such amounts. Because Company will be reimbursed for audit costs, it is incentivized to audit third-party contractors to identify incorrect billings, and is reimbursed for both the audit costs and incorrect billings. Although Company would normally be reimbursed for incorrect billings and the associated 10-percent markup under the SSA and CSA, the subsidization of Company's auditing is likely to identify more incorrect billings than under the SSA and CSA. This is because, under the SSA and CSA, you are responsible for auditing and have less incentive to audit third parties. Therefore, Company stands to benefit under the Agreement from the subsidized auditing activity. You cite the cap on audit costs as a benefit to you under the Agreement. The cap for reimbursements for audit costs is capped at x3 percent of the original fund amount. Given that the cap allows for approximately x4 dollars in audit costs, however, the cap is so high that it is not meaningful.

Under the Agreement, you will also reimburse Company for collection costs for which you would normally be liable under the SSA and CSA. Company will be reimbursed for collection costs in recovering incorrect billings and for the 10-percent markup on the amount it recovers. Because Company will be reimbursed for collection costs, it is incentivized to undertake collection activities so that it can be reimbursed for the 10-percent markup on such amounts. Although Company would normally be reimbursed for the recovered incorrect billing amounts under the SSA and CSA, the subsidization of Company's collection activity is likely to cause Company to recover more incorrect billings and be reimbursed for more 10-percent markups on such amounts. This is because, under the SSA and CSA, you are responsible for collections and have less incentive to collect amounts from third parties. You cite the cap on collection costs as a benefit to you under the Agreement. The cap for reimbursements for collection costs is the lesser of x5 percent of amounts collected or x6 percent of the original fund amount. Given that the cap allows for reimbursement of millions of dollars in collection costs, this cap, like the cap on audit costs, is also not particularly meaningful.

As described above, the Agreement reduces the amount Company is required to pay under the SSA and CSA, changing the basis upon which you charge Company, a member of Parent, for your services. You have never reduced the amounts you charge for cleanup services in hundreds of service calls, either for members or nonmembers of Parent. Now, however, you propose to discount the amounts you charge for cleanup services for a member of Parent that is represented on the Board of Parent. Because you will charge a member of Parent (i.e., Company) on a different basis from nonmembers, and at a preferential price, you are not like the organization in Rev. Rul. 79-316, supra. Accordingly, upon making such payments pursuant to the Agreement, you may not be operated exclusively for the promotion of social welfare under § 501(c)(4). See Rev. Rul. 79-316, supra, and Contracting Plumbers Cooperative Restoration Corp. v. United States, 468 F.2d 684 (2d Cir. 1973). As a result, you may jeopardize your exemption under § 501(c)(4).

No part of the net earnings of an organization exempt under § 501(c)(4) may inure to the benefit of any private shareholder or individual. The inurement prohibition requires an organization not to pass its earnings to its founder, or the members of its board or their families, or anyone else fairly to be described as an insider — that is, as the equivalent of an owner or manager. United Cancer Council, Inc. v. Comm'r., 165 F.3d 1173 (7th Cir. 1999). The test is functional: it looks to the reality of control rather than to the insider's place in a formal table of organization. The insider could be a mere employee or even a nominal outsider, such as a physician with hospital privileges in a charitable hospital. Similarly, the prohibition on inurement denies exempt status to an organization

whose founders or controlling members have a personal stake in that organization's receipts. People of God Community v. Comm'r., 75 T.C. 127 (1980).

"Net earnings," in the context of the prohibition on inurement, is a broader term than net profits according to financial statements. If a particular individual or limited number of individuals reaps commercial benefits from the operation of an instrumentality, though they do not do so by direct acquisition or payment over to them of its earnings, the earnings may nevertheless inure to their benefit. Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974). The term "net earnings" may even include refreshments, goods, and services furnished to members of an exempt organization. Spokane Motorcycle Club v. United States, 222 F. Supp. 151 (E.D. Wash. 1963).

An agreement for fixed-percentage compensation of a radiologist does not result in inurement when the agreement results from arms-length negotiation and the radiologist has no control over, or management authority with respect to, the hospital. Rev. Rul. 69-383, 1969-2 C.B. 113.

Here, Company can fairly be described as an insider with respect to you. See United Cancer Council v. Comm'r, 165 F.3d 1173 (7th Cir. 1999). Company is the equivalent of an owner or manager with respect to you, given that it has a voice in the control of Parent through its representative on Parent's board. Parent is your sole member, its board has control over you and, by virtue of its representation on Parent's board, Company has a voice in controlling you. As a member of Parent that stands to benefit from the Agreement, Company has a personal stake in your receipts. See People of God Community v. Comm'r, 75 T.C. 127 (1980).

You state that Company's representative, Director, recused himself from Parent's board meetings during deliberations and voting on the Agreement. He was, however, present for discussions of the Agreement. As described, the transaction appears to be at arm's-length. Nonetheless, you are different from the radiologist in Revenue Ruling 69-383, supra, because Company has a degree of control over you by virtue of its representation on the board of Parent, which is the sole and controlling member of you. Company is therefore distinguishable from the radiologist in the revenue ruling and can be described as an insider with respect to you.

You cite the unprecedented size of the Incident as the main reason you were willing to negotiate with Company, but you have never reduced the amount you charge for cleanup services for any member or nonmember of Parent. Neither do you propose to make any changes to the SSA to address the problem of similar clean up situations in the future. The only instance in which you have been willing to reduce the fees you charge is with a member of Parent that is also an insider with respect to you. Because you have not reduced your standard cleanup charges and you state that you do not plan to change the SSA going forward, it appears that Company's status as an insider may have influenced your willingness to negotiate with Company. Regardless of whether Company's status as an insider influenced your willingness to negotiate, the Agreement you have negotiated with Company, in fact, benefits Company by relieving it of amounts it owes you under the SSA in return for illusory benefits in your favor. Also, regardless of whether Company's status as an insider actually influenced your decision to accept the Agreement, the Agreement does, in fact, benefit an insider with respect to you.

Given that Company is an insider with respect to you, the reduction of Company's liability under the SSA, pursuant to the Agreement, effectively reduces the price Company pays for your services. Such a reduction in liability, or in price for services, qualifies as "net earnings" within the meaning of section 501(c)(4). See Harding Hospital, inc. v. United States, 505 F.2d 1068 (6th Cir. 1974). The reimbursement of Company for expenses for which it is liable to you under the SSA from the Agreement fund will cause your net earnings to inure to the benefit of Company. As a result of your providing services at a preferential price to Company, you will no longer be operated exclusively for

the promotion of social welfare and accordingly, your status under § 501(c)(4) will be adversely affected.

CONCLUSION

Based on the foregoing, we rule as follows:

Payments made to Company pursuant to the Agreement will adversely affect your tax-exempt status under § 501(c)(4) and will result in inurement to Company by you.

This ruling will be made available for public inspection under § 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, Notice of Intention to Disclose. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records. If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

In accordance with the Power of Attorney currently on file with the Internal Revenue Service, we are sending a copy of this letter to your authorized representative.

Sincerely,

Theodore R. Lieber

Manager, Exempt Organizations

Technical Group 3