
IRS LTR: Arrangements Won't Hurt Group's Tax-Exempt Status.

The IRS ruled that modified arrangements in which several senior executive employees of a tax-exempt organization would become employees of a corporation and then would be "seconded" back to the organization would not adversely affect the organization's tax-exempt status.

Contact Person: * * *
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UIL: 501.00-00, 501.03-00, 501.33-00
Release Date: 5/9/2014
Date: February 14, 2014
Employer Identification Number: * * *

LEGEND:

Corporation = * * *
Year = * * *

Dear * * *:

This is in response to your letter dated January 26, 2012, in which you requested a ruling that if you implement a proposed modification to an existing secondment arrangement, you will continue to be recognized as a tax-exempt organization described in § 501(c)(3) of the Internal Revenue Code of 1986, as amended (Code). This letter supersedes our letter dated December 20, 2013, which is hereby withdrawn.

FACTS

You have been recognized as an organization exempt under § 501(c)(3) of the Code and classified as an organization other than a private foundation because you normally receive a substantial part of your support from contributions from the general public, within the meaning of §§ 509(a)(1) and 170(b)(1)(A)(vi). Your charitable purposes are to receive and administer funds for religious, charitable, scientific, and educational purposes. You also are a sponsoring organization for donor advised funds within the meaning of § 4966(d)(1) that makes grants from your investment income and assets. You are an independent organization associated with Corporation.You propose to make changes to the workforce arrangement that you currently have with Corporation. Under the proposal, three of your senior executive employees would become employees of Corporation and then would be seconded back to you. Currently, all of your staff except for these three employees are employed by Corporationand seconded to you on a full-time basis. Your existing Administrative Services Agreement with Corporation would be amended to cover payroll services and employee benefits for the three additional employees. The Administrative Services Agreement provides that you will pay Corporation annually an administrative fee not to exceed five basis points times the

average daily balance of all donor-advised fund accounts maintained by you, which shall be due and payable quarterly. Corporation maintains the right to waive or reduce this fee at any time. Amounts payable are to be reviewed annually to ensure that all amounts payable are priced at or below fair market value. However, you state that Corporation has waived this fee for you and provided these services and infrastructure free of charge since Year.

You will continue to be independent of Corporation. The changes to your Administrative Services Agreement will have no effect on your Board of Directors. Your Board of Directors consists of one employee of Corporation and five independent directors. Your Board of Directors meets three times a year to address your strategy and progress, to approve recommendations from committees, and to review and approve grants made, among other things. The three employees who will be added to the Administrative Service Agreement attend all Board meetings as your top officials and inform the Board of your day-to-day operations. The approval and appointment of these three employees will continue to be made by the Board on an annual basis. You maintain full control of whether or not any seconded employee remains your employee. You maintain the responsibility of interviewing, negotiating compensation and benefits, and approving the hiring of any employee that will be seconded to you. And, you also maintain control over future negotiations and decisions regarding compensation and benefits for any seconded employees.

You state that after the three senior executive employees are seconded back to you, you will continue to be organized and operated for the charitable purpose of promoting philanthropy and will not confer on any party any impermissible private benefit or private inurement. You also represent that corporate law dictates that a duty of loyalty is owed to you, rather than to Corporation, once the employees are seconded to you.

In addition to the independent control and management performed by your Board of Directors, you also offer many options for donor advised funds to make investments in addition to those offered by Corporation. You offer a variety of investment pools featuring top performing mutual funds. Half of these funds are offered through other investment firms. Additionally, donors to larger accounts are permitted to have the funds in such accounts be managed by independent investment advisors who are not associated with Corporation.

RULING REQUESTED

- You will continue to be recognized as a tax-exempt organization described in § 501(c)(3) if you implement the proposed modification to the existing Administrative Services Agreement.

LAW

I.R.C. § 501(c)(3) provides that organizations may be exempted from tax if they are organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes and "no part of the net earnings of which inures to the benefit of any private shareholder or individual."Treas. Reg. § 1.501(c)(3)-1(a)(1) provides that in order to be exempt under § 501(c)(3), an organization must be both organized and operated exclusively for one or more of the exempt purposes specified in that section.

Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. To meet the requirement of this subsection, the burden of proof is on the organization to show 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.

Revenue Ruling 70-186, 1970-1 C.B. 128, discusses an organization formed to preserve and enhance a lake as a public recreational facility by treating the water. The lake is large, bordering on several municipalities. The public uses it extensively for recreation. Along its shores are public beaches, launching ramps, and other public facilities. The organization is financed by contributions from lake front property owners, members of the adjacent community, and municipalities bordering the lake. The revenue ruling concludes that the benefits from the organization's activities flow principally to the general public through well-maintained and improved public recreational facilities. Any private benefits derived by the lake front property owners do not lessen the public benefits flowing from the organization's operations. In fact, it would be impossible for the organization to accomplish its purposes without providing benefits to the lake front property owners.

Revenue Ruling 73-407, 1973-2 C.B. 383, states that a contribution by a private foundation to a public charity that was conditioned upon the agreement of the public charity to change its name to that of a substantial contributor to the private foundation and not to change it again for 100 years was not an act of self-dealing because the resulting benefit to the substantial contributor was incidental and tenuous, and not economic in nature.

Revenue Ruling 98-15, 1998-1 C.B. 718, provides two scenarios where exempt hospitals enter joint ventures with for-profit hospitals. In the first scenario, the exempt hospital maintains control of the board and the day-to-day operations of the LLC that owns the hospital. The governing documents of the LLC require it to operate any hospital it owns in a manner that furthers charitable purposes by promoting health for a broad cross section of its community. In the event of a conflict between operation in accordance with the community benefit standard and any duty to maximize profits, the members of the governing board are to satisfy the community benefit standard without regard to the consequences for maximizing profitability. In addition, all returns of capital and distributions of earnings made to owners of the LLC are to be proportional to their ownership interests in the LLC. The terms of the governing documents are legal, binding, and enforceable under applicable state law.

In the second scenario of Revenue Ruling 98-15, control and management of the hospital is transferred to an LLC, the board of directors of which consists of three members appointed by the exempt organization and three appointed by the for-profit. Major operating decisions (budgets, distributions of earnings, etc.) have to be approved by a majority of the board.

In both scenarios, the exempt hospitals receive income interests in proportion to the assets contributed to the joint ventures. Only in the first scenario was the hospital activity considered to continue as an exempt activity and not to be operated for the private benefit of the for-profit hospital.

In Church by Mail v. Commissioner, 765 F.2d 1387 (9th Cir. 1985), aff'g 48 T.C.M. (CCH) 471 (1984), the Tax Court found it unnecessary to consider the reasonableness of payments made by the applicant to a business owned by its officers. The 9th Circuit Court of Appeals, in affirming the Tax Court's decision, stated: "The critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially from the operation of the Church."

Broadway Theatre League of Lynchburg, Virginia v. U.S., 293 F. Supp. 346, 355 (D.C. VA. 1968), states that "An organization can incur ordinary and necessary expenditures in its regular activities without losing its exempt status.St. Germain Foundation v. Commission, 26 TC 648 (1956); A. A. Allen Revivals, Inc., PH TC Memo 1963-281. A contract entered into by a foundation, for its benefit, even if the contract is responsible for the creation of the foundation, is not necessarily as a matter of

law executed to avoid taxation. Commissioner of Internal Revenue v. Orton, 173 F.2d 483 (6th Cir. 1949)."

In est of Hawaii v. Commissioner, 71 T.C. 1067, 1081-82 (1979), the Tax Court held that compensation need not be unreasonable or exceed fair market value to constitute private benefit, stating "[n]or can we agree with petitioner that the critical inquiry is whether the payments made to International were reasonable or excessive. Regardless of whether the payments made by petitioner to International were excessive, International and EST, Inc., benefited substantially from the operation of petitioner."

In P.L.L. Scholarship v. Commissioner, 82 T.C. 196 (1984), the Tax Court found that an organization that operated charitable bingo on the premises of a bar allowed the bar to increase its sales of food and drinks by its operations in the bar, thereby benefiting the bar in more than an insubstantial way. The organization and bar were controlled by some of the same persons. The Court held that the operations of the organization and bar were so interrelated as to be "functionally inseparable," the effect of which was that any economic benefit the bar received was not incidental.

In International Postgraduate Medical Foundation v. Commissioner, T.C. Memo 1989-36; 56 T.C.M. (CCH) 1140 (1989), an organization, the activity of which was to conduct continuing medical education tours abroad and which exclusively used one for-profit travel agency to arrange its travel tours, was found not to be operated exclusively for purposes described in § 501(c)(3). The same individuals controlled both the organization and the for-profit travel agency, and the organization did not solicit bids from any other travel agency. Both entities shared the same office. The Tax Court found that the organization was not operated exclusively for one or more exempt purposes because of its provision of benefits to the travel agency.

ANALYSIS

To continue to qualify as an exempt organization described in § 501(c)(3), you must be organized and operated for one or more exempt purposes. Section 1.501(c)(3)-1(a)(1). An organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. To meet this requirement, the burden of proof is on the organization to show that it is not organized or operated for the benefit of private interests, such as designated individuals, its creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests. Section 1.501(c)(3)-1(d)(1)(ii).You propose to make changes to your workforce arrangement with Corporation. Under the proposal, three of your current employees will become employees of Corporation. Under the Administrative Services Agreement between you and Corporation, those same three employees would be seconded back to you. In addition, your Administrative Services Agreement would be amended to cover the payroll services and employee benefits for those three employees.

In certain cases, an organization contracting its services away may be found to no longer perform an exempt function because it has contracted out all of its activities and control. This is not the case with you, however, as your Board of Directors continues to be independent of Corporation. Additionally, an organization is permitted to contract out some services for a fee to a for-profit corporation without jeopardizing its tax exemption. See Broadway Theatre, 293 F. Supp. at 355. Your Board of Directors will still meet quarterly to evaluate and approve your grants for charitable purposes, despite the contract for administrative and employment services. Additionally, your funds will be used to pay for the seconded employees, and they will remain responsive to you. You will determine the employees' compensation and whether or not they will remain employed by Corporation for your purposes. Furthermore, you represent that corporate law cases have determined that such seconded employees owe a duty of loyalty to you, rather than to Corporation.

Given your exercise of control over the seconded employees and your operations through your independent Board of Directors, you have not contracted away your exempt activities.

Additionally, in order to be operated for an exempt purpose, you must be operated for a public, rather than private, benefit. Section 1.501(c)(3)-1(d)(1)(ii). When assessing whether an organization is formed for a private benefit, "the critical inquiry is not whether particular contractual payments to a related for-profit organization are reasonable or excessive, but instead whether the entire enterprise is carried on in such a manner that the for-profit organization benefits substantially" from the operation of the exempt organization. Church by Mail, 765 F.2d at 1392. One way in which a for-profit organization might benefit substantially from the operation of an exempt organization is by being the exclusive client of that for-profit. This is especially true in cases where both the for-profit and the non-profit are controlled by the same persons. In Church by Mail, 765 F.2d 1387, the for-profit organization ran a printing business for the church's publications, which was the non-profit's sole purpose. The printing company had been started by the founders of the church and operated exclusively to provide printing for that church. The for-profit printing company would not have existed if not for the existence of the church. Also, in est of Hawaii, 71 T.C. 1067, the non-profit school exclusively taught the lessons of a for-profit company run by employees of another, related for-profit company. The non-profit purchased, taught, and promoted exclusively the material of the for-profit company. There, the purpose of the non-profit was determined to be the distribution and collection of income for the for-profit company. Here, however, business from you constitutes less than one percent of the business of Corporation, and you are not controlled by Corporation. The separation of control, combined with the fact that your operations do not serve to "substantially benefit" Corporation, suggests that you are not operated for the private benefit of Corporation.

Additionally, an organization might be operated for private benefit if it exclusively uses a related for-profit to provide its services without seeking out the best possible service provider, International Postgraduate, 56 T.C.M. (CCH) 1140, or if its operations are conducted in a manner that any external business is sent exclusively to that for-profit.P.L.L. Scholarship, 82 T.C. 196. This is especially true when the non-profit and for-profit organizations are controlled by the same persons. Again, you and Corporation are not controlled by the same persons. Additionally, you do not exclusively use the investment products of Corporation; rather, you provide donors with the opportunity to invest in outside funds. Furthermore, you allow large donors to select outside fund advisors. The access to outside investment products and advisors also means that the operation of your program does not merely act as a means to provide business opportunities to Corporation through a captive audience, such as the one in P.L.L. Scholarship, 82 T.C. 196.

While you do contract exclusively with Corporation for your Administrative Service Agreement, the agreement provides for the use of the employees at cost, as if you were employing them directly, and Corporation has waived any fees for the administrative services since Year. Therefore, there has been no financial gain to Corporation in the Administrative Services Agreement. Any private benefit that may be gained by Corporation in providing you with seconded employees, including your highest ranking executives, is incidental. See Rev. Rul. 70-186, supra(indicating that specific benefits to a defined group may be incidental to the performance of an exempt organization and, thus, are not incompatible with tax exemption). Rev. Rul. 98-15, supra, describes two scenarios where tax exempt organizations enter joint ventures with for-profit corporations. In the first scenario, the tax exempt organization maintains control over the joint venture and is able to ensure that its operations further the charitable purpose of the tax-exempt organization. The for-profit organization that enters the joint venture receives a proportionate amount of any income generated by the joint venture, but this sharing of revenue is considered to be incidental to the furtherance of the exempt organization's purpose, furthered by the joint venture. Here, your activities create income for Corporation through the investment activities of your donor-advised funds, but this

income represents less than one percent of Corporation's overall income, and you maintain control over your funds and activities through an independent board, as described above. Your continued control over your activities allows you to further your own exempt purpose and not the private benefit of Corporation. You are not operated for the private benefit of Corporation, and the inclusion of your highest ranking employees in your Administrative Services Agreement is not incompatible with your tax exemption under § 501(a).

RULING

- Implementation of the proposed modification to the existing secondment arrangement between you and

Corporation

- will not adversely affect your status as a tax-exempt organization described in § 501(c)(3).

This ruling will be made available for public inspection under § 6110 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) 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,
- Ronald Shoemaker
- Manager, Exempt Organizations
- Technical Group 2

Enclosure
Notice 437

Citations: LTR 201419015