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First Bite and the Private Benefit Doctrine: A Comment on Temporary and Proposed Regulation 53.4958-4T(a)(3)

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"FIRST BITE" AND THE PRIVATE BENEFIT DOCTRINE: A COMMENT ON TEMPORARY AND PROPOSED REGULATION 53.4958-4T(a)(3)

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"But of the fruit of the tree which is in the midst of the garden,"
God hath said, "Ye shall not eat of it, neither shall ye touch it, lest ye die."[1]

I. INTRODUCTION

One interpretation of the Bible is that humankind's terminal fate was sealed after the first bite of the proverbial apple so long ago. The harm, apparently, was such that a violation was as worthy of the fullest consequence upon the first instance as it might have been upon any subsequent instance. The severity of the harm made it unnecessary to await a subsequent violation. It was, therefore, after the very first bite that mankind was banished from paradise.

Charitable organizations, too, enjoy a paradise of sorts. Indeed, to be free of taxation might be the closest that humankind can expect to get to paradise. Other than the pursuit of charity, no other joint economic undertaking escapes taxation. But as with the Biblical residence in paradise, there is one, and only one, unyielding condition imposed on those who undertake charitable activities.[2] Those who stand in the relationship of "owner" vis-à-vis the charity may never share in the charity's surplus wealth. To state the matter in the Tax Code's ("the Code") technical jargon, no part of an organization's net earnings may inure to the benefit of an insider.[3] A violation of that

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1. *Genesis* 3:3.

2. Some might argue, not unreasonably, that there are two unyielding conditions with respect to the grant of tax exemption. The statute granting charities tax exemption absolutely prohibits the distribution of profit. I.R.C. § 501(c)(3) (2000) (all references to tax statutes are to those under the 1986 code, as amended). It also absolutely prohibits such organizations from intervening in any political campaign. *Id.* However, I do not consider the political intervention prohibition to be an inherent condition of tax exemption as is the prohibition against profit distribution. *See generally* Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. 575 (2000).

3. I.R.C. § 501(c)(3) (2000).

commandment, no matter how small, justifies immediate revocation of tax exemption.[4] Profit taking is apparently so inimical to the concept of charity that the first violation is sufficient to warrant the full consequence.[5]

That consequence, revocation of tax exemption, oftentimes has repercussions felt by more than just the charity itself, or the insiders who caused the charity to violate the commandment. Revoking tax exemption will normally result in the elimination or decrease in the amount of goods or services provided in a charitable manner, and in some instances may have no effect on the insiders. For this reason, Congress thought it wise to enact a system of "intermediate sanctions,"[6] by which to precisely punish insiders without harming the beneficiaries who depend upon the organization's tax-exempt existence. Congress confirmed that profit taking is indeed inimical to tax exemption, but also held out the possibility that the charity would suffer something less than the complete loss of exemption upon any single instance of profit taking. Essentially, an insider who violates the profit-taking prohibition is hit with a 25% excise tax and, in addition, must either return the ill-gotten gains to the charity or pay twice the amount to the government.[7] The organization still faces the possibility of revocation, but that consequence and its unintended repercussions are no longer inevitable.

Still, Congress has never redefined the fundamental commandment such that a first violation would completely escape consequence. Recent events, though, have made that result more than a hypothetical possibility. First, there was the Seventh Circuit's decision in *United Cancer Council, Inc. v. Commissioner*,[8] wherein Judge Posner adhered to the letter, if not the spirit of I.R.C. § 501(c)(3) and appeared to explicitly adopt the "first bite" rule. The letter of I.R.C. § 501(c)(3) prevents the distribution of profit to "insiders"—correctly defined by Judge Posner to mean a director, manager or person of similar authority or stature within the organization.[9] Technically, a person who is on the verge of being hired as such is not an insider at the time of the hiring. At the moment immediately before hiring, the person is an "outsider." As a result, her fortuitous negotiation of a contract that pays her an unreasonable amount—that is, a contract resulting in the distribution of

4. *See* Jones, *supra* note 2 (providing a history and extensive analysis of the prohibition against profit taking).

5. *Id.*

6. *See* I.R.C. § 4958 (2000).

7. I.R.C. § 4958(a)-(b) (2000).

8. 165 F.3d 1173 (7th Cir. 1999).

9. *Id.* at 1176.

profit—does not violate the literal commandment. The latter day insider is thus allowed a "first bite" at the entity's profits without fear of causing the revocation of tax exemption.

Judge Posner's opinion came at a time when the Service was actively fighting the first bite rule on another front. Before and after the Service's first set of proposed regulations concerning the new intermediate sanctions scheme,[10] many commentators argued that no profit taking sanction is authorized when a charity distributes profit to a person via a contract made when the recipient was not yet an insider.[11] That is, the prohibition against profit taking should not apply until after the recipient becomes a literal insider and then only if she receives profit by virtue of a new arrangement unrelated to the first arrangement. Such a rule, like that in *United Cancer Council, Inc.*, would essentially mean that a latter day insider might have already taken profit from the charity without fear of consequence. The Service rejected calls to explicitly include such a rule in its first set of regulations, but Judge Posner's opinion was issued in the midst of the rulemaking process. The opinion made it much more likely that years of rulemaking would succumb, at least in part, to a successful challenge if the rules were finally implemented without the first bite rule.

Understandably, when the Service revised the proposed regulations and reissued them in both temporary and proposed form, it conceded the literal statutory and judicial support for the rule by explicitly excluding latter day insiders from sanction.[12] As a result, there now exists what might rightly be viewed as the proverbial loophole through which a charity's profit might be distributed with impunity. Although the Service felt compelled to concede its very technical error, it appears also to have unnecessarily conceded the entire fight concerning the improper distribution of profit. Judge Posner's opinion hardly requires such a result. In fact, the opinion most clearly indicates that another doctrine—the prohibition against private benefit—should be used to address profit distributions when made to a person who is an outsider.[13] But while the Service complied with Posner's first dictate—that it refrain from exacting a punishment against an outsider under the prohibition against profit

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10. Prop. Treas. Reg. §§ 53.4958-0-53.4958-7, 63 Fed. Reg. 41,486 (Aug. 4, 1998).

11. 66 Fed. Reg. 2150 (Jan. 10, 2001) ("Several comments received during the regular comment period requested that a person having no prior relationship with an organization not be considered a disqualified person [i.e., an insider and therefore subject to sanction] with respect to the first contractual arrangement with the organization.").

12. Temp. Treas. Reg. § 53.4958-4T(a)(3) (2001).

13. *United Cancer Council, Inc.*, 165 F.3d at 1179-80.

taking—it completely ignored his corresponding and eminently correct suggestion that punishment should be had under the theory of private benefit.

Perhaps one reason for the Service's undertaking of only half the job with respect to prohibiting a charity's distribution of profit is that the theory of private benefit is, at this very moment, so incorrectly stated and doctrinally muddled as to be rendered useless. The Service's informal adherence to a theory of private benefit entirely contrary to that stated in its regulations is proof enough of this assertion.[14] As formally posited in the regulations, the private benefit doctrine might even force the Service to stand idly by while profits are distributed under the protective language of the first bite rule.

The purpose of this article, then, is first to show how the Service's concession to the first bite rule, without a corresponding restatement of the private benefit doctrine, renders the public powerless to prevent a charity's distribution of profit in certain significant circumstances. In the absence of corrective action, the more aggressive and savvy charities will quickly recognize and exploit the loophole. Second, the article discusses and refines a proposal I have previously made concerning a restatement of the private benefit doctrine in a manner that would close the loophole.[15] Since the private benefit doctrine is very closely related to the prohibition against profit distribution (yet distinguishable nevertheless), it seems only logical that a revision of one rule would occasion a reconsideration of the other. In Part II, I briefly outline the facts and holding of *United Cancer Council, Inc.* In Part III, I summarize the details of Temporary/Proposed Regulation § 53.4958-4T(a)(3) and provide some speculative predictions from the viewpoint of a charity that seeks to circumvent the prohibition against profit taking. In Part IV, I compare the Service's formal and informal articulations of the private benefit rule and conclude that the informal articulation is better. In Part V, I redefine and restate the doctrine of private benefit in a manner that addresses the distribution of profit much more predictably than would the present formal articulation of that doctrine.

II. *UNITED CANCER COUNCIL, INC.* AND THE BIRTH OF THE FIRST BITE RULE

United Cancer Council, Inc. was never explicitly about the first bite rule, at least not at the appellate level. Nevertheless, the rule might be viewed as

14. *See* Gen. Couns. Mem. 39,862 (Nov. 21, 1991).

15. *See* Darryll K. Jones, *Private Benefit and The Unanswered Questions From Redlands*, 89 TAX NOTES 121 (2000).

a logical outgrowth of Judge Posner's opinion in that case. The United Cancer Council, Inc. ("UCC") was an offshoot of the American Cancer Society, that focused on preventing and ameliorating the effects of cancer, rather than searching for a cure.[16] In 1984, UCC hired a corporate fundraiser, with which it had no previous connection, to raise funds for UCC under an exclusive contract.[17] Over the course of five years, the fundraiser raised nearly $29 million dollars on behalf of UCC, but nearly $27 million went to the fundraiser as compensation and expense reimbursements. Only approximately $2 million over five years went to UCC's charitable purpose.[18] The Service argued, and the Tax Court agreed, that because the fundraiser had exclusive control over UCC's fundraising campaign, including UCC's mailing list, it occupied a status akin to "owner" vis-à-vis UCC and was therefore an insider.[19] The Tax Court specifically rejected UCC's argument that the fundraiser was not yet an insider and therefore could not have violated the prohibition against profit taking at the time of the agreement. In particular, the Tax Court stated that it was not aware of any such "one-free-bite" principle.[20] Having found that the fundraiser was an insider, the Tax Court went on to conclude that the payments made were entirely unreasonable and, therefore, violated the prohibition against profit taking.[21]

Judge Posner, speaking for a three-judge panel of the Seventh Circuit Court of Appeals, reversed the Tax Court, though he never mentioned the first bite rule. It was, of course, undisputed that prior to entering into the contract, whereby it took nearly 95% of UCC's gross "earnings," the fundraiser could not be described as an "insider" within the meaning of I.R.C. § 501(c)(3). As a matter of strict statutory construction, the Court was not entirely unreasonable in concluding that the prohibition against profit taking did not apply to UCC at the time of the contract. But UCC could have been deemed an insider at the moment right after the contract was signed, and therefore any profit taking thereafter would violate the prohibition. Indeed, Judge Posner acknowledged that even an outside fundraiser could be an insider,[22] but rejected the finding in this case, apparently because the contract had been negotiated with the fundraiser prior to the fundraiser having any connection

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16. *United Cancer Council, Inc.*, 165 F.3d at 1174.
17. *Id.* at 1175.
18. *Id.*
19. *Id.* at 1176.
20. United Cancer Council, Inc. v. Commissioner, 109 T.C. 326, 388 (1997), *rev'd*, 165 F.3d 1173 (7th Cir. 1999).
21. *Id.* at 397.
22. *United Cancer Council, Inc.*, 165 F.3d at 1176.

to UCC. Taken by itself, this holding suggests that the Service has no weapon by which to combat profit distribution so long as the recipient was not an insider prior to the distribution.

There is some basis in the opinion, though, from which to conclude the Seventh Circuit may have ruled otherwise if it thought the public had no other way of preventing the diversion of profit from the charitable cause. After determining that the Tax Court was incorrect in finding that the fundraiser was an insider, Judge Posner suggested a different theory by which the Service might have rectified the apparent distribution of profit:

> Maybe tax law has a role to play in assuring the prudent management of charities. Remember the IRS's alternative basis for yanking UCC's exemption? It is that as a result of the contract's terms, UCC was not really operated exclusively for charitable purposes, but rather for the private benefit of [the fundraiser] as well. Suppose that UCC was so irresponsibly managed that it paid [the fundraiser] twice as much for fundraising services as [the fundraiser] would have been happy to accept for those services, so that of UCC's $26 million in fundraising expense $13 million was the equivalent of a gift to the fundraiser. Then it could be argued that UCC was in fact being operated to a significant degree for the private benefit of [the fundraiser], though not because [the fundraiser] was [an insider]. That then would be a route for using tax law to deal with the problems of improvident or extravagant expenditures by a charitable organization... [T]he board of a charity has a duty of care, just like the board of an ordinary business corporation, and a violation of that duty which involved the dissipation of the charity's assets might... support a finding that the charity was conferring a private benefit.[23]

The dicta suggests that the Seventh Circuit did not believe that its holding regarding the inapplicability of the profit taking prohibition to latter day insiders left the Service and the public without any remedy at all. Indeed, in light of the dicta, it would be surprising indeed to think the Court meant to condone a rule that allowed such persons one free bite at charity's profit apple. As discussed in the next section, though, the Service proposes to implement only the first half of *United Cancer Council, Inc.* The Service formally concedes that diverting profit to an outsider does not violate the prohibition against profit taking, but has not elaborated upon, nor otherwise asserted, the notion that diverting profit to latter day insiders violates another provision of law.

23. *Id.* at 1179.

III. TEMPORARY AND PROPOSED REGULATION § 53.4958-4T(A)(3): FORMAL ADOPTION OF THE FIRST BITE RULE

Prior to *United Cancer Council, Inc.*, the Service requested public comments on forthcoming regulations pertaining to the intermediate sanctions provision.[24] Comments received in response to both the request and the subsequently proposed regulations specifically sought the adoption of the first bite rule.[25] The Service rather obliquely rejected the first bite rule by including an example whereby a previously unrelated party was deemed an insider by virtue of its first ever transaction with a charity and thereafter subject to the profit taking prohibition and sanctions with respect to that very same transaction.[26] In response to *United Cancer Council Inc.*, however, the Service withdrew that example and issued new temporary and proposed regulations adopting the first bite rule.[27] In doing so, the Service specifically discussed that part of *United Cancer Council*'s holding that the prohibition against profit taking was inapplicable to a latter day insider,[28] suggesting that that the reversal was practically mandated by the Seventh Circuit's decision. But the Service did not discuss the court's suggestion of an alternative approach to prevent the diversion of charitable profits to non-insiders. Because it neglected to take up and elaborate upon the court's alternative approach, the Service has most likely precipitated the sort of mischief not contemplated by the court, and which quite correctly motivated the Service's initial refusal to adopt the first bite rule.

Simply put, Temporary and Proposed Regulation § 53.4958-4T(a)(3) provides that sanctions for violating the prohibition against profit taking will not apply when a fixed payment is made pursuant to the first agreement between a charity and a person previously unrelated to the charity. A fixed payment is, in essence, a payment that is determinable solely by the objective terms of an initial agreement.[29] The payment may be determined by application of a formula stated in the agreement, which formula may be based upon the organization's net revenue, but may not otherwise be subject to the discretion of any person with respect to whether the payment is to be made or

24. I.R.S. Notice 96-46, 1996-2 C.B. 212.
25. Prop. Treas. Reg. §§ 53.4958-0-53.4958-7, 63 Fed. Reg. 41,486 (Aug. 4, 1998).
26. Prop. Treas. Reg. § 53.4958-3(f), Example 3, 63 Fed. Reg. 41,499 (Aug. 4, 1998).
27. *See* Temp. Treas. Reg. 53.4958-4T(a)(3) (2001).
28. 66 Fed. Reg. 2150 (Jan. 10, 2001).
29. Temp. Treas. Reg. § 53-4958-4T(a)(3)(ii)(A) (2001).

the amount of payment.[30] Thus, although the recipient may become an insider by virtue of the agreement—for example, when a charity hires a previously unassociated person to act as its CEO—and thereafter receives a salary far in excess of what is reasonable, no sanction will apply for violation of the profit-taking prohibitions. In essence, the latter day insider is allowed to take as big a first bite of the charity's profits as he can get, without fear of sanction.

A brief example demonstrates the mischief that might result from such a rule. Suppose, for example, that a tax-exempt hospital heavily oriented towards expensive, inpatient specialty care seeks to acquire general practitioners and their practices to make itself more competitive in the managed care environment. Suppose also that only a few physician practice groups, none of which are insiders with respect to the hospital, operate in the community served by the tax-exempt health care organization, and at least one for-profit hospital serves the same community. In order to entice as many general practitioners to its employ, the tax-exempt hospital might be willing to pay far more than market price for both the physicians' practice assets and their future services as hospital staff physicians. Under the first bite rule, the hospital could pay highly inflated prices for the physician practice assets. Thereafter, the hospital could employ the practitioners under separate contract, paying them only reasonable salaries. The inflated amounts paid for the practice assets would actually serve as a means of frontloading a distribution of profit to potential latter day insiders. The first bite rule, though, would preclude the Service from attacking the hospital's payment of inflated prices for the practice assets because at the time of the agreement, the physicians would not yet have become insiders.[31]

The Seventh Circuit would undoubtedly agree with the result in the hypothetical above insofar as the prohibition against profit taking is concerned. But the court probably would have gone further to suggest that perhaps the hospital's course of conduct supports a determination that it was operating for the private benefit of the physicians. Unfortunately, however, the present regulatory articulation of the private benefit doctrine might not allow the Service to take action in response to the hypothetical. As the next section demonstrates, the private benefit rule, as presently articulated, would

30. *Id.*

31. At one time, the Service held the opinion that physicians were "insiders" with respect to the hospital for whom they provided services. In enacting IRC§ 4958, Congress stated (albeit in committee report only) that physicians should not automatically be deemed "insiders," but should be considered "insiders" only if the particular facts and circumstances support such a conclusion. H.R. REP. NO. 104-56, at 157 (1996).

probably provide redress only in the most extreme cases such as that presented in *United Cancer Council, Inc.* Where a charity is not so singularly identifiable with or dependent upon a single bad transaction, but distributes profit nevertheless, the private benefit doctrine as presently articulated will be of little use.

IV. FIRST BITE AND PRIVATE BENEFIT

The Service has actually been of two minds with regard to the private benefit doctrine, at least since 1991. On the one hand, Treasury Regulation § 1.501(c)(3)-1, which contains the Service's formal articulation of the private benefit doctrine, lends itself to the conclusion that an "insubstantial" amount of private benefit will not occasion the revocation of tax exemption. Substantiality is a relative term that compares the private benefit conveyed with the public good achieved by the charity. If the private benefit is insubstantial, relative to the overall good achieved, there is no private benefit violation under present law. In fact, this is the precise holding of *American Campaign Academy v. Commissioner*,[32] wherein the Tax Court interpreted the Service's regulation thusly:

> [S]hould petitioner be shown to benefit private interests, it will be deemed to further a nonexempt purpose under section 1.501(c)(3)-1(d)(1)(ii). This non-exempt purpose will prevent petitioner from operating primarily for exempt purposes [and therefore occasion revocation of tax exemption] *absent a showing that no more than an insubstantial part of its activities further the private interests or any other nonexempt purpose.*[33]

As Judge Posner suggested, this articulation of the private benefit doctrine might very well have provided a basis for redressing the distribution that occurred in *United Cancer Council, Inc.* If nearly 95% of a charity's tax exempt revenues are used to finance a single private business, it can easily be concluded that the private benefit is substantial relative to the public good and that tax exemption should be revoked.[34] The Service's formal articulation is therefore sufficient in the extreme cases.

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32. 92 T.C. 1053 (1989).

33. *Id.* at 1066 (emphasis added).

34. In February 2000, *United Cancer Council, Inc.* entered into a closing agreement with the service whereby UCC agreed that its tax exemption would be revoked for the period January 1, 1986 to January 1, 1990, and that it would stop engaging in public fundraising efforts (though it may continue to accept unsolicited donations). *See United Cancer Council Closing Agreement Released*, 28 EXEMPT. ORG. TAX REV. 250 (2000).

But what about the less extreme, but more common, cases represented by our hospital hypothetical in Part III? If we assume the hospital had an overall operating budget of $40 million and over the course of a year or two paid inflated prices aggregating $400,000 in purchasing five different physician practices, can it really be said that the misappropriation amounting to 1% of the hospital's budget is "substantial" and, therefore, justifies revoking tax exemption under the private benefit doctrine as formally articulated? What if the inflated purchase price is paid to just one physician who thereafter is hired as the hospital's chief medical officer? In either case, tax exemption has contributed to making a noncharitable beneficiary wealthy, and most likely at the expense of the public good that should otherwise have been achieved with the inflated purchase price. The formal articulation does not allow redress if the expenditure was entirely inappropriate but nevertheless insubstantial. The best that can be said is that it is highly debatable that the private benefit doctrine would serve to rectify the situation, as perhaps the Seventh Circuit assumed. Clearly, then, the combination of the first bite rule and the private benefit doctrine as formally articulated creates an insufferable loophole through which profit may be distributed.

Informally, though, the Service has defined the private benefit doctrine in a manner that would redress the result hypothesized above. In General Counsel Memorandum 39862,[35] the Service explained the private benefit theory thusly:

> [Prologue:] Any private benefit arising from a particular activity must be "incidental" in both a qualitative and quantitative sense to the overall public benefit achieved by the activity if the organization is to remain exempt.
> [1.] To be qualitatively incidental, a private benefit must occur as a necessary concomitant of the activity that benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefiting private individuals. Such benefits might also be characterized as indirect or unintentional.
> [2.] To be quantitatively incidental, a benefit must be insubstantial when viewed in relation to the public benefit conferred by the activity.
> [Epilogue:] It bears emphasis that, even though exemption of the entire organization may be at stake, the private benefit conferred by an activity or arrangement is balanced only against the public benefit conferred by that activity or arrangement, not the overall good accomplished by the organization.[36]

Under the Service's informal articulation, private benefit can be violated, first, if the benefit provided is unnecessary to the accomplishment of a

35. Gen. Couns. Mem. 39,862 (Nov. 21, 1991). General Counsel Memoranda do not constitute binding legal authority.
36. *Id.*

charitable goal and, second, if the benefit conferred is substantial in relationship to the public good derived solely from the activity conferring the private benefit, not from the aggregate of activities conducted by the charitable organization. Under Part 2 of the Service's informal articulation, the fact that our hypothetical hospital spends 99% of its store pursuing charitable goals would not mean that it could otherwise give away 1% of the store. Even that one percent is the public's wealth. This is to be contrasted with the formal articulation of the private benefit doctrine, which would only be violated if the private benefit is simply too much to be tolerated relative to the overall good achieved by the organization, regardless of its appropriateness. The formal articulation would condone the result of the first bite rule in our hypothetical. The informal articulation would not.

We can know that the Service's informal articulation is the better approach through an application of what John Rawls called "reflective equilibrium."[37] That is, we posit a rule that appears to provide the best solution in the abstract. We then test that rule by application to particular facts. If upon application to particular facts we arrive at an absurd or insufferable result, we should revise the rule so that it does not allow for such a result. By this process we first posit and then continually revise until we have eliminated absurd results to the extent possible.

The question for present purposes is whether it is absurd or insufferable that tax exemption should continue when a charity spends a portion of its publicly subsidized wealth in a manner that does not benefit the public, but instead conveys a private benefit that is "insubstantial" relative to the aggregate public good achieved. A second question, one posed by the Seventh Circuit and Part 2 of the Service's informal articulation, is whether tax exemption remains appropriate when even an otherwise appropriate expenditure yields so little public good relative to the private benefit derived solely by the expenditure. In the extreme cases such as that presented in *United Cancer Council, Inc.*, we might easily conclude that maintaining tax exemption is absurd and that the formal articulation of the private benefit doctrine is sufficient to address the result. But in the more common, less extreme cases, such as that presented by our hypothetical, the formal articulation is insufficient though the private profit taking may be as equally absurd or insufferable. It should never make any sense—i.e., it is presumptively absurd—that a publicly subsidized entity should be allowed to give away part of the store to private interests without question simply

37. JOHN RAWLS, A THEORY OF JUSTICE 49-51 (1971).

because it uses the better part of its store for public good. Suppose, for example, that instead of overpaying latter day insiders, our hypothetical hospital simply made a gift of $400,000 to a city official who was soon (but only later) to become the hospital's CEO. The first bite rule and the formal articulation of the private benefit doctrine would not allow for redress since the distribution was not made to an insider and, still, only 1% of the hospital's resources have been improperly diverted. Only the informal articulation would provide a basis for redress by asking first whether the expenditure was even appropriate, regardless of its substantiality.

Note, too, that the informal approach does not necessarily condemn the distribution to an outsider in our asset purchase hypothetical. Instead, it allows the Service (the public's representative, after all) to question the distribution's appropriateness, regardless of its substantiality. If the distribution is found to be inappropriate, the Service may take corrective action, up to and including revocation, without further inquiry. If the distribution is found to be appropriate, the Service may then ask whether the cost outweighs the benefit, as the Seventh Circuit in *United Cancer Council, Inc.* suggested. The formal approach not only ignores the appropriateness of the distribution but also condemns the distribution only in the rare instances that the distribution can be viewed as "substantial" relative to the entire universe of the hospital's activities. The absurdity of that result—providing the public with no occasion to question the appropriateness of a distribution, however small in a relative sense, and then condemning even an inappropriate distribution only when it is substantial in a global sense—demands that we reconsider the articulation of private benefit so that such a result is not possible.

V. REDEFINING PRIVATE BENEFIT TO STEM THE FIRST BITE LOSS

The first bite rule, when applied in conjunction with the private benefit doctrine as presently articulated, would allow for a significant diversion of tax exempt wealth to private interests. Perhaps it is no coincidence that the Seventh Circuit's opinion, to which the Service pointed in codifying the first bite rule, never explicitly or directly referred to the rule. The opinion cannot fairly be read as condoning an improper distribution of wealth. Instead, the opinion merely indicates that the prohibition against profit taking was the wrong theory by which to address such distributions. It is not unreasonable to assume, based upon the Court's explicit discussion to that effect, that the Court nevertheless thought it appropriate that a charity's publicly subsidized wealth never be used for private benefit. The Court appears to assume that the private benefit doctrine would reach those distributions to which the profit-taking prohibition does not apply. In the prior section, however, we have seen that the Court may have assumed too much. The private benefit doctrine as presently articulated would most likely have provided redress for the distribution of profit in *United Cancer Council, Inc.* But many more instances of improper distributions would be unaffected by the presently articulated private benefit doctrine. Thus, if the Service intends to finalize the regulations containing the first bite rule, it should also restate the private benefit doctrine to avoid a result surely not contemplated by the Seventh Circuit or good tax policy.

So that my thesis goes beyond offering mere hypothetical solutions to real problems, I now provide an annotated version of a proposed restatement of the private benefit doctrine.[38] Each asserted provision or related group of provisions is followed by a brief comment describing the source and/or purpose of the assertion.

1.501(c)(3)-1(d): Private Benefit

(i) To be entitled to tax exemption, an organization must benefit the public exclusively. Thus, to be tax exempt, an organization must not convey a priority right of beneficial interaction to a select and identifiable person or group. Except as provided in subparagraph (ii), conveyance of such priority right results in and constitutes private benefit.

(a) A priority right of beneficial interaction results whenever a select and identifiable individual or group has a right to an organization's direct or indirect beneficial effect, in any form or manner, greater than that enjoyed by the nonselect and unidentifiable general public. Solely for purposes of this subparagraph, it is irrelevant that the select and identifiable individual or group must pay a fair price for the greater right.

(b) A select and identifiable individual or group, is not present merely because an organization makes available any of its beneficial effect only to those who pay for the beneficial effect.

Comment: The present articulation of the private benefit doctrine does not actually define private benefit. The leading case, *American Campaign Academy v. Commissioner*, defines private benefit as an "advantage, profit, fruit, privilege, gain, or interest." Those terms hardly suggest a common factor and are therefore unhelpful in describing the underlying policy of private benefit, or the instances in which courts have found private benefit. The proposed rule defines private benefit as the conveyance of a "priority right of beneficial interaction to a select and identifiable group or individual." The phrase is intended to describe circumstances in which the charity is directing its beneficial effect to a defined individual or group of individuals rather than to the unidentifiable individuals that comprise the "public."[39] The *American Campaign Academy* definition often lends itself to the argument that private benefit cannot occur

38. I first proposed the following articulation in Jones, *supra* note 15, at 138-39.

39. For a more in-depth discussion of this point, *see id.* at 131-32.

where the select group of individuals with whom a charity is transacting must pay a fair price. Such a requirement, though, mistakenly views the private benefit doctrine as one which requires only that a charity receive a fair price, and ignores the axiomatic assertion that charities must operate exclusively for the public's benefit and may not operate otherwise even if it is being adequately compensated for its goods or services. To allow a charity to operate for the benefit of a few ignores the nature of publicly subsidized entities having a duty to provide a *quid pro quo* to the public. Finally, an entity that provides services solely to those who are able to pay is not thereby serving identifiable private interests. It may be that the entity is not engaging in charity, but that is a different and broader assertion than that the entity is serving private interest.

(ii) Private benefit does not result if the organization conveys a priority right of beneficial interaction to a select and identifiable individual or group, provided the following conditions apply:

(a) The public benefit to be achieved thereby is within the purposes for which exemption is granted under I.R.C. § 501(c)(3),

(b) The public benefit cannot be achieved without conveying the priority right of beneficial interaction to the select and identifiable individual or group, and

(c) Any betterment resulting exclusively to the select and identifiable person or group as a result of the priority right of beneficial interaction is insubstantial, when viewed solely in relation to the public benefit conferred by the activity and not in relation to all other activities engaged in by the organization.

Comment: The present articulation of the private benefit doctrine nowhere allows the public to question the propriety of an expenditure of publicly subsidized funds. Instead, present doctrine seems only to challenge an expenditure insofar as it may be extravagant when compared to the overall good achieved by the organization. That is, under present law the public may question only the amount of an expenditure and then only in relation to the organization's overall expenditures. The public may not question the purpose for which public wealth is spent. The proposed rule follows General Counsel Memorandum 39862 and allows the public to question the purpose of an expenditure regardless of its amount. If the expenditure which conveys or comprises a priority right of beneficial interaction to an individual or group is not required to achieve a purpose for which tax exemption is granted, the expenditure results in private benefit. In addition, the private benefit must not be so significant relative to the public good achieved solely by the expenditure. The public, through its executive and judicial branch, should be allowed to question the cost, *ex ante*, of achieving a public good previously defined as worthy of tax exemption.

(iii) An organization that conveys private benefit is not entitled to tax exemption, even though it may otherwise meet the "exclusively operated" requirement under Treas. Reg. § 1.501(c)(3)-1(d)(1). Thus, an organization that engages in eight separate charitable activities, only one of which conveys a priority right of beneficial interaction to a select and identifiable group, is not entitled to tax exemption even though the private benefit is insubstantial when compared to the public good achieved by all of the organization's activities.

Comment: Present law is inappropriately skewed towards leaving the public without a remedy when a publicly subsidized organization makes an inappropriate expenditure. Except in the most extreme cases, such as that presented in *United Cancer Council, Inc. v. Commissioner*, present law condones an improper expenditure. As an organization's expenditures for the public good increase, it is allowed to convey greater amounts of private benefit, because a sanction may be imposed under present law only when the private benefit is substantial as compared to the organization's public good. The proposed rule, which also follows General Counsel Memorandum 39862, would cure the anomaly embodied in the notion that the more a charity benefits the public, the more it may also benefit private interests.

VI. CONCLUSION

Undoubtedly, the bigger interests in the charitable community—hospitals, universities, and international disaster relief organizations—will object to the proposal in this article. The objection will be that organizations that spend millions in pursuit of their charitable goal should not be at risk of revocation because of a relatively small diversion. The objection is legitimate, but relates to a separate issue. Whether an expenditure or activity offends the theory upon which tax exemption is granted—that tax exemption assists in the accomplishment of a public good—is a separate issue from the sanction that should be imposed upon a violation of that theory. Of course, the sanction should be tailored to prevent unnecessary harm, just as the intermediate sanctions provision is designed to provide redress a distribution of profit to insiders without harming beneficiaries. But the harm itself must first be correctly defined and articulated separately from the determination of the proper sanction. We should not ignore a real affront to tax exemption simply because we do not like the sole available sanction. Obviously, we should correctly define and articulate the harm, as this article attempts to do, and then define a proper sanction.