

New Private Letter Ruling Disregards Separate Existence of a Charity and Related Noncharity

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A non-profit organization (the "Applicant") decided to operate a charitable endeavor it called "Facts" and "Acts". The idea was that the Applicant's website would host a news aggregation site, together with links to donate to recognized charities. So, for instance, the website might link a story about a natural disaster (Facts) with a link to contribute money, blankets or water to the victims (Acts). The website would also host a social networking system so like minded donors and organizations could connect and network. No fees would be charged to website users as the Applicant intended to rely on fundraising to cover costs. Because these activities appear charitable, the Applicant sought exemption under IRC § 501(c)(3).

Part of the website development plan involved operating a for-profit subsidiary. The affiliate was to generate taxable revenue through advertising and strategic partnerships. The affiliate would use data drawn from the website, in exchange for a licensing fee, to facilitate its for profit, taxable operations. Any excess funds would be directed to the non-profit to augment the non-profit's fundraising efforts. No exemption was sought with respect to the for-profit subsidiary.

The Internal Revenue Service ("IRS") denied the non-profit's request for recognition as a public charity. Despite the clear fact that this involved two legally independent entities, one seeking exemption as a charity and the other not seeking exemption, the IRS found it too difficult to distinguish between the Applicant's charitable activities and the for-profit activities of the subsidiary. Therefore, the IRS attributed the for-profit activities of the subsidiary to the non-profit, rendering it non-exempt.

Attribution cases are always fact driven. In this case, the IRS cited to the following facts as illustrations of the lack of independence between the Applicant and its for-profit subsidiary:

1. there was no evidence that the for-profit subsidiary would pay the Applicant a fair market price for the license to use its technology (that is, there was a concern that the entities would not deal with each other at arms length),
2. the for-profit subsidiary would have control over the Applicant's activities, through common employees and directors, sufficient to ensure that the Applicant's activities aided the for-profit's operations; and
3. there was no evidence that the decision regarding (a) whether the creation of a for-profit subsidiary, or (b) whether to enter into the technology license agreement with the subsidiary, was made in accordance with the Applicant's conflict of interest policy or even limited to a board of disinterested persons.

As a result, the IRS concluded that there was no meaningful separation between the two entities. Therefore, the IRS disregarded the legal separation between the entities, finding that the facts required that the for-profit's activities be attributed to the Applicant.

Application to Fraternity Foundations

It might be easy to dismiss this case because it dealt with the interplay between a non-profit and a for profit entity. However, these concepts are equally applicable to the fraternity-foundation relationship!

As we have written many times before, legal independence of two companies is generally recognized by the IRS and courts. But, where two companies have a relationship, whether arising from shared missions, shared history or shared management, expect the IRS and the courts to look deeper. Is there common control? If so, does the non-charity fraternity run the charitable foundation? Are the employees the same? How is the charity making decisions about its relationship with the non-charity? Are decision making policies in place and, more importantly, being followed? In short, is the charity merely an extension of the non-charity, functioning for the benefit of the non-charity? In the case above, the answers to these questions doomed the charitable exemption.

Due to the close relationship between fraternity foundations and fraternities, separateness is always an issue. If proper separation is not maintained, the fraternity could be disregarded as a separate entity and its activities attributed to the foundation. While beyond the scope of this alert, we will simply state that this is a bad result! Take the steps necessary to stay separate!