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## The Private Benefit Doctrine: Practical Considerations for Nonprofits

Nonprofits frequently engage with for-profit businesses or individuals in the ordinary course of business or as part of a particular charitable program. As many nonprofit leaders are aware, such engagement can raise legal issues when an insider of the organization (e.g., Board member, executive director) is in some way associated with the for-profit.

What may be less obvious—and is the subject of this Legal Alert—are the legal issues that arise when a nonprofit provides a benefit to an unrelated for-profit or an individual that is not in any way related to any insiders of the organization. Specifically, this situation can violate what is termed the “private benefit doctrine” under federal law.<sup>1</sup> This Legal Alert will give a brief overview of the private benefit doctrine, then turn to examples to illustrate how the doctrine has been or might be applied. Each example will be accompanied by an explanation of the issue and some practical guidance to better comply with federal law.

### Private Benefit Doctrine: Overview

Federal tax regulations state that a nonprofit organization may be tax-exempt under 501(c)(3) of the Internal Revenue Code (the Code) only if “it serves a public rather than private interest.”<sup>2</sup> This is not to say that a nonprofit can never serve a “private interest.” Federal law permits nonprofits to serve a private interest where it is “incidental” to the public interest (or charitable purpose) the organization fundamentally serves. Importantly, impermissible private benefit need not be monetary (for example, free promotion for a for-profit business is a private benefit) and may be found even where the private benefit does not go to a nonprofit insider. Taken together, the federal United States Tax Court has stated the rule succinctly in defining impermissible private benefit as “nonincidental benefits conferred on disinterested persons” that serve private interests.<sup>3</sup>

A nonprofit can clearly buy market-rate goods that it needs to carry out its mission. But when does interaction with profit-making entities cross the line from incidental to nonincidental?

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<sup>1</sup> Readers should note that the private benefit doctrine is a broad principle in nonprofit law that also encompasses situations where a nonprofit provides charitable goods or services to an excessively narrow group of individuals, rather than specifically for-profit enterprises. For example, where residents of a particular city block form a nonprofit organization to preserve and beautify that particular city block (see Rev. Rul. 75-286). While these scenarios raise public benefit issues, this is not the focus of this legal alert.

<sup>2</sup> [26 CFR 1.501\(c\)\(3\)-1\(d\)\(1\)\(ii\)](#)

<sup>3</sup> [American Campaign Academy v. Commissioner, 92 T.C. 1053 \(1989\)](#); see also [Overview of Inurement/Private Benefit Issues in IRC 501\(c\)\(3\), IRS \(1990\)](#) (providing one of the most thorough explanations on the private benefit doctrine by the IRS).

## Incidental Private Benefit

This may sound like legal jargon. To break it down into more practical terms, the key question for nonprofit leaders is: “how much private benefit is too much?” Or, to put it in terms used in federal tax law: “when is private benefit merely incidental (and therefore permissible) to my nonprofit’s charitable activities?” The answer to these questions is important because the sole penalty for a violation of the private benefit doctrine is revocation of 501(c)(3) tax-exempt status.

Whether a given amount of private benefit is permissible depends on: (1) the magnitude of the private benefit as compared with the public benefit of the particular charitable activity; and (2) whether the private benefit is necessary in order to further the public benefit.<sup>4</sup> These elements are usually referred to as, respectively, the quantitative and qualitative elements of incidental private benefit. In sum, a private benefit is incidental (i.e. permissible) where the private benefit is insubstantial relative to the public benefit (quantitative) and necessary to achieve the public benefit (qualitative).

To illustrate with two examples selected from IRS Revenue Rulings, a nonprofit organization whose primary charitable purpose was to promote community interest and appreciation for classical music sought sponsors and solicited listeners for a for-profit classical music radio station, creating a private benefit in the form of a “public relations campaign” for the station.<sup>5</sup> Although one could argue these activities also provided a charitable public benefit by supporting classical music in the community, because the private interest was relatively large (the quantitative element), these activities produced impermissible private benefit. In another example, a nonprofit organization formed to preserve a lake and improve its recreational facilities produced private benefits to the lakefront property owners. However, because the benefit to the lakefront property owners did not lessen the benefit to the public at large, nor could the public benefit be achieved without also benefiting lakefront property owners, the Tax Court found the private benefits to be merely incidental (the qualitative element).<sup>6</sup>

## **Practical Private Benefit Issues for Nonprofits**

### Job Training & Placement Programs

*Example: Nonprofit, “Job Trainers,” is dedicated to training low-income bilingual youth in translation services and helping place them in gainful employment. After completing a 10-week training program, Job Trainers sends all trainees to work for a for-profit translation services company, “Translators LLC.” Job Trainers and Translators LLC have an agreement that the latter will hire every Job Trainers trainee that successfully completes the training program, and employ them at \$25/hour, an amount somewhat higher than the average rate.*

Job Trainers’ activities in this example would almost certainly be producing an impermissible private benefit to Translators LLC. This example is similar to a real case, *American Campaign Academy v. Commissioner*, where a nonprofit, American Campaign Academy, formed for the charitable purpose of training individuals for careers as political campaign professionals, but nearly all of its graduates were

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<sup>4</sup> [Overview of Inurement/Private Benefit Issues in IRC 501\(c\)\(3\), IRS \(1990\)](#); see also, [Private Benefit under IRC 501\(c\)\(3\), IRS \(2001\)](#)

<sup>5</sup> See, [Rev. Rul. 76-206](#)

<sup>6</sup> See, [Rev. Rul. 70-186](#)

eventually employed by the Republican Party.<sup>7</sup> The Tax Court recognized that such training or job placement programs necessarily produce secondary private benefits to future employers, but held that American Campaign Academy's activities produced an impermissible private benefit to a particular private entity, the Republican Party, rather than spreading such benefit across the industry.

The example above is even more problematic. Although Job Trainers' job placement activity is charitable, it places graduates by express agreement with Translators LLC. It is immaterial that the trainees get a higher than average pay. The issue, like in *American Campaign Academy*, is that job placement is not spread across the industry and so all private benefit goes to a single for-profit entity, Translators LLC.

#### *Practical Guidance*

Job Trainers could modify its program and improve its chances of compliance with the Code by making two simple modifications to the program. First, it should avoid a direct contractual agreement with Translators LLC to hire every graduate. Job Trainers may want to consider drafting a non-binding Memorandum of Understanding whereby Translators LLC will consider Job Trainers' candidates (for example, a pledge to receive and review resumes by such candidates). Second, Job Trainers should find other translator services organizations to place graduates with. There is no magic number, but it should certainly be more than a single for-profit business. The private benefit doctrine is highly fact dependent, so the IRS will consider context specific factors like the number of businesses in the particular industry.

#### Supporting Small Businesses, Artisans, and Artists

*Example: Nonprofit, "Biz Dev," provides below market loans and free promotion to local businesses to spur economic activity in its predominately low-income community. Biz Dev chooses businesses to support based on simple selection criteria: the business must operate within the community and it must provide a convincing explanation of why Biz Dev's support would substantially improve the business' prospects.*

Biz Dev's business support activities in this example likely produce an impermissible private benefit to the businessowners. Although one could argue that such support provides a public benefit in the form of economic development in an economically depressed community, the private benefit to the business owners is probably too substantial in comparison with the public benefit in this case.

#### *Practical Guidance*

Biz Dev could likely come into compliance with the Code if it made modifications to its program, particularly around its criteria for selecting businesses. An IRS Revenue Ruling (which provides official guidance on tax law based on real cases) for a similar nonprofit business development organization found it served a public rather than private interest in its business support activities largely due to its careful selection of beneficiaries.<sup>8</sup> Unlike Biz Dev, the organization in the Revenue Ruling provided a substantial community benefit because it selected businesses that: (1) would provide training and employment opportunities for unemployed and under-employed residents of the local community; (2) were minority-owned, which promotes the social welfare of the community by lessening prejudice and discrimination against a minority group; and (3) filled a specific community need and demonstrated the greatest potential for community benefit.

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<sup>7</sup> *American Campaign Academy v. Comm'r*, 92 T.C. 1053 (1989)

<sup>8</sup> [Rev. Rul. 74-587](#)

*Example: Nonprofit, “Local Crafts,” supports local artisans in an economically depressed community by hosting a community crafts market every weekend in its parking lot. Local Crafts arbitrarily selects local artisans to participate in the market, with the only requirement that they be residents of the local community. Local Crafts spends substantial resources promoting the market in the community, highlights specific artisans, and allows selected participants to set up their stall in the market for free.*

For much the same reasons as the *Biz Dev* example above, based on these facts alone Local Crafts likely produces an impermissible private benefit to the artisans through its crafts market activity. Again, although the program may have community economic benefits in an economically depressed community, the vague selection criteria does not ensure the public benefit will significantly outweigh any private benefit to the artisans. Moreover, it may be more difficult to avoid impermissible private benefit in this example given that, unlike modifications that could be made to the *Biz Dev* example, artisans are usually sole proprietors that do not employ others, so such a program likely will not produce the recognized public benefit of providing training and employment opportunities for unemployed and under-employed residents.

#### *Practical Guidance*

Certain modifications could be made to the Local Crafts example to improve its chances of compliance with the Code. First, Local Crafts could improve its selection criteria by focusing on, for example, artisans of color, artisans that have a history of unemployment and underemployment, artisans that produce goods with a community benefit (for example, nutritious baked goods or beverages in a food desert community), and artisans that pledge to hire and train underemployed youth as apprentices. Second, Local Crafts could tie the crafts market to its own training program, where, rather than provide a private benefit to established artisans, the crafts market would be a short-term opportunity for trainee graduates to learn marketing skills for their new business.

*Example: “Indie Artists” is a nonprofit organization formed to promote visual arts in the community and educate the public on regional trends in modern art by displaying local up-and-coming artists in its public gallery and allowing members of the public to purchase the art (collecting a below-market, 10% commission on the sale and giving the remainder to the artists).*

The art sales activity of Indie Artists produces an impermissible private benefit to the local artists, as explicitly noted in the Code regulations.<sup>9</sup> This example differs from the previous two in an important respect. The potential public benefits in the previous two examples include relief of the poor and combating community deterioration, each of which are recognized charitable purposes by the relevant Code regulations.<sup>10</sup> In those examples, the secondary benefit to small businesses or artisans is necessary for, and therefore incidental to, relieving the poor and combating community deterioration through targeted efforts to improve job prospects for the unemployed or boost the local economy. On the other hand, the recognized public benefit for Indie Artists, like most similar arts nonprofits, is to educate the public on the arts.<sup>11</sup> Thus, Indie Artists faces a unique difficulty in that, while showcasing the art

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<sup>9</sup> [26 CFR 1.501\(c\)\(3\)-1\(d\)\(1\)\(iii\)](#)

<sup>10</sup> [26 CFR 1.501\(c\)\(3\)-1\(d\)\(2\)](#)

<sup>11</sup> See [26 CFR 1.501\(c\)\(3\)-1\(d\)\(3\)\(ii\)](#) (citing “museum” as an example of an educational organization); see also [Rev. Rul. 66-178](#) and [Rev. Rul. 65-271](#) (recognizing arts organizations as tax-exempt under 501(c)(3) for their educational purposes).

gratuitously to the public would be permissible as educational,<sup>12</sup> *selling* the art and giving the proceeds to the artist is likely not necessary for the public benefit of education.

### *Practical Guidance*

This is not to say that an arts nonprofit organization can never pay individual artists as part of its charitable mission, as noted in a Revenue Ruling where the IRS found no issue with an arts organization dedicated to promoting jazz music paying professional musicians to perform at public festivals.<sup>13</sup> There are a few modifications Indie Artists could make to operate its program without violating the private benefit doctrine. First, as noted above, Indie Artists could display the artwork gratuitously to the public, and although this would produce a private benefit in the form of promotion of the artist, the IRS generally finds this permissible. Second, Indie Artists could connect its art sales to a training program and reframe the charitable purpose. For example, Indie Artists could likely provide an arts training program for domestic violence survivors (or any disadvantaged group) to provide them a means of independently supporting themselves, then allow graduates of the program to sell their art at the gallery at the conclusion of the program as a way to learn the commercial side of art. Third, to better approximate the jazz organization in the Revenue Ruling described above, Indie Artists may be able to display artists' work for a reasonable fee, or even sell the works but keep a significantly larger portion of the proceeds to re-invest in other charitable activities (and ensure most of the monetary benefit does not go to the individual artist).

### **Final Thoughts**

The private benefit doctrine is loosely defined and its application is heavily dependent on the facts and circumstances of a particular case—details that can never be adequately addressed in a short hypothetical. With that in mind, we conclude here with a couple of high-level principles that capture the themes and concepts explored above:

- Private benefit issues may arise when any individual or entity receives a benefit (whether monetary or not) from the nonprofit, regardless of whether the individual or entity is connected to an insider of the organization.
- Precisely distinguishing between the quantitative and qualitative elements of incidental private benefits is less important than simply remembering to ask yourself whenever a private benefit potentially exists the following two questions: “is the private benefit insubstantial as compared with the anticipated public benefit?” and “is the private benefit necessary to achieve the public benefit sought?”
- Developing a job training and placement program necessarily produces secondary private benefits to future employers, but a nonprofit can avoid private benefit issues if it reasonably spreads placements across the industry, rather than to a single or narrow set of employers.
- When a nonprofit sets out to support a for-profit entity (whether a small business or a sole proprietor artisan), it should always ensure the selection criteria is narrowly tailored to the public benefit sought (e.g., supporting minority owned businesses, supporting businesses that pledge to hire and train unemployed residents from the community, or supporting enterprises that otherwise will have a widely dispersed community benefit or meet a community need).
- Organizations looking to support (financially or by promotion) individuals or entities for reasons other than economic development (as in the arts organization examples) should try to limit the

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<sup>12</sup> See [Rev. Rul. 66-178](#)

<sup>13</sup> [Rev. Rul. 65-271](#)

private benefit to only what is necessary to achieve the public benefit (for example, limit the private benefit to promotion for artists by displaying works gratuitously to the public) or tie the private benefit to an additional, separate public benefit (e.g., training disadvantaged artists to start a career in the field).

- When in doubt, contact Lawyers Alliance to discuss how we can help you navigate private benefit issues and comply with the Code.

***This alert is meant to provide general information only, not legal advice. If you have any questions about this alert please contact Rafi Stern at [rstern@lawyersalliance.org](mailto:rstern@lawyersalliance.org) or visit our website at [www.lawyersalliance.org](http://www.lawyersalliance.org) for further information. To become a client, visit [www.lawyersalliance.org/becoming-a-client](http://www.lawyersalliance.org/becoming-a-client).***

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