United Cancer Council, Inc. v. Commissioner, 109 T. C. 326 (1997)

Excessive compensation to insiders can violate the prohibition on inurement of net earnings under tax-exempt status rules.

Summary

United Cancer Council, Inc. (UCC) entered a fundraising contract with Watson and Hughey Company (W&H) that led to the IRS revoking UCC's tax-exempt status retroactively to the contract's start date. The Tax Court held that W&H was an insider due to its control over UCC's fundraising activities and finances, and the compensation W&H received was excessive, resulting in inurement of UCC's net earnings to W&H. The court upheld the retroactive revocation, finding no abuse of discretion by the IRS. This case underscores the importance of ensuring that compensation to insiders does not exceed reasonable levels and highlights the risks of arrangements that grant significant control to third parties.

Facts

UCC, organized in 1963, was granted tax-exempt status in 1969. Facing financial difficulties in 1984, UCC entered a five-year fundraising contract with W&H. Under the contract, W&H provided funds for UCC's operations and fundraising, controlled the fundraising campaign, and retained co-ownership rights to UCC's mailing list. UCC paid W&H over $4 million in fees and nearly $4 million in list rental fees, while W&H exploited the mailing list for additional income. The IRS revoked UCC's tax-exempt status retroactively to June 11, 1984, the start of the contract, citing inurement of net earnings to W&H.

Procedural History

UCC received its tax-exempt status in 1969. After entering the contract with W&H in 1984, the IRS reviewed UCC's activities and revoked its tax-exempt status in 1990, effective from June 11, 1984. UCC challenged this revocation in the Tax Court, which heard the case and issued its decision in 1997.

Issue(s)

1. Whether W&H was an insider for the purposes of the inurement provisions of sections 501(c)(3) and 170(c)(2)(C) of the Internal Revenue Code.
2. Whether there was an inurement of net earnings to W&H, causing UCC to fail to qualify as an exempt organization or as an eligible charitable donee.
3. Whether the IRS's retroactive revocation of UCC's favorable ruling letter back to June 11, 1984, was an abuse of discretion.

Holding

1. Yes, because W&H exercised substantial control over UCC's fundraising and

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finances, making it an insider.
2. Yes, because the compensation W&H received, including direct payments and the value of its use of UCC's mailing list, exceeded reasonable compensation, resulting in inurement of net earnings to W&H.
3. No, because the retroactive revocation was not an abuse of discretion, as the inurement violation began with the contract's start.

Court's Reasoning

The court determined that W&H was an insider due to its significant control over UCC's fundraising and financial operations, despite not being a formal officer or director. W&H's control was evident in its management of UCC's fundraising campaign, control over the escrow account, and restrictions on UCC's use of its own mailing list. The court found that the compensation W&H received was excessive, considering the market rates for similar services and the lack of checks on W&H's compensation in the contract. The court also upheld the retroactive revocation, noting that the inurement violation began with the contract and that a prospective-only revocation would be meaningless. The court considered expert testimony but concluded that the compensation structure was not reasonable under the circumstances.

Practical Implications

This decision emphasizes the need for tax-exempt organizations to carefully structure their contracts with third parties to avoid inurement issues. Organizations should ensure that compensation to insiders or those with significant control is reasonable and documented. The case also highlights the importance of maintaining control over key assets, such as mailing lists, and the potential risks of granting co-ownership rights. Practitioners should advise clients to review and negotiate contracts carefully, ensuring that any third-party control is limited and justified. The decision also underscores the IRS's authority to retroactively revoke tax-exempt status when inurement violations occur, reinforcing the need for ongoing compliance with tax-exempt requirements.

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