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Court Revokes 501(C)(3) Status Over "Scrip" Program That Provided Reduced Dues to Participating Members: Exempt Organizations Should Review Fundraising Activities and Member Discounts

Charitable organizations often encourage members to fundraise by creating incentives for those members who do the most. A recent case from the United States Tax Court (*Capital Gymnastics Booster Club, Inc. v. Comm'r*., T.C. Memo 2013-193) demonstrates that one method of encouraging fundraising (*i.e.*, reducing dues for members who participate in fundraising) can cause a charitable organization to lose its tax-exempt status. Charitable organizations should reexamine their fundraising policies to avoid sacrificing their charitable status.

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Background

Charitable status under Internal Revenue Code (the Code) section 501(c)(3) provides organizations with many benefits, including exemption from federal income taxes. In addition, donations received by the organizations are typically deductible, providing financial incentive to donors. One common form of fundraising is a "scrip" program through which a merchant sells gift certificates to charitable organizations for less than their face value and then the organization sells the certificates at full price, retaining the difference as a fundraising profit. Fundraising programs like scrip programs typically require an organization to furnish evidence of its tax-exempt status before the organization can participate. Based on the *Capital Gymnastics* case, however, an organization could jeopardize its tax-exempt status if it provides special benefits to participants of the organization's fundraising programs.

Capital Gymnastics

In *Capital Gymnastics*, the United States Tax Court ruled that a gymnastics booster club failed to satisfy the requirements of Code section 501(c)(3) when it reduced membership dues based on the amount of funds raised by each member through various fundraisers, including a scrip program.

In the case, the booster club operated to address the costs of gymnastics competitions. The members each had an annual assessment to pay based on the member's anticipated costs of competition entry fees and coaches' costs. The organization provided no scholarships or relaxation of the assessments. Instead, the organization created a system where each family that participated in fundraising activities received "points" equivalent to the amount of money raised by the family; these points could be used to offset the assessments. The scrip program allowed members to purchase gift certificates to stores where they already shop and reduce their assessments at the same time. For example, a grocery store might provide a $100 gift certificate to the booster club for $95, and when the member bought it from the club for $100, the $5 would go to the club. Under the organization's program, the member who bought the scrip would be credited with $5 worth of points. The members who did not participate in fundraising were not allocated any of the fundraising profits.

Code section 501(c)(3) provides tax-exempt status for many kinds of organizations "organized and operated exclusively" for a specific purpose, including "to foster national or international amateur sports competition," as long as certain requirements are met. One of those requirements is that "no part of the net earnings . . . inures to the benefit of any private shareholder or individual." Inurement can result when an organization provides special benefits to "insiders," such as members or officers, and any amount of private inurement results in disqualification as a charitable organization.

The primary function of the booster club was to fundraise. The Tax Court therefore distinguished it from other organizations where fundraising was only a tiny fraction of its overall function, such as a school band selling candy for new uniforms. The Tax Court also distinguished the point system from activities of other charitable organizations where the benefits were not deliberately focused on the organization's own members or the beneficiaries were not selected by its members. Instead, the Tax Court likened it to the *Parker* case (*Wendy L. Parker Rehabilitation Foundation, Inc. v. Comm'r*., T.C. Memo. 1986-348), where the organization lost its charitable status because the organization's founder's daughter was selected as the beneficiary of 30% of the organization's income.

In *Capital Gymnastics*, the Tax Court held that the booster club failed to operate exclusively for charitable purposes because it had a substantial non-exempt purpose of furthering the interests of those members who participated in fundraising and that its earnings inured to the benefit of those members. The Tax Court explained: "When an organization benefits members without regard to their being in a charitable class, it fails to further an exempt purpose."

Action Items

Exempt organizations should be careful when establishing fundraising programs that benefit insiders, including benefits like the reduction of dues or member assessments. Groups may also want to review existing programs to minimize risk of private inurement.