

CAPITAL GYMNASTICS—A CAUTIONARY IRS MESSAGE TO BOOSTER CLUBS

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In *Capital Gymnastics Booster Club, Inc.*, TCM 2013-193, a memorandum opinion issued last August, the Tax Court sustained the decision of the IRS to revoke the tax exemption of an amateur athletics booster club. Judge David Gustafson concluded the club's operations violated the **private inurement** and **private benefit** prohibitions applicable to charitable, tax-exempt organizations. The club therefore failed to operate **exclusively** for charitable purposes and so was not entitled to exemption under Section 501(c)(3).

Capital Gymnastics Booster Club is a modestly sized organization by almost any standard. During its 2003 fiscal year (the one examined by the IRS), its membership consisted of approximately 240 families who were the parents of amateur gymnasts. At the end of fiscal year (FY) 2003, the Club had approximately \$27,000 in assets and operated at a loss for the year. Some observers might find it curious that the IRS would select this organization for audit and then pursue a case against it through the Tax Court.

It is important to note that, while most booster organizations tend to be relatively small operations, there are many of them. According to a search on Guidestar, there are more than 12,000 tax-exempt booster clubs in the United States. Moreover, the IRS has long been concerned about how many of these organizations operate and, in particular, how they generate financial support.¹ Typically, these clubs are funded almost entirely by the contributions of parents of children who participate in the athletic program or other activity that the booster club supports. Insuring broad support among these parent-members is often critical to the success of the organization. As a result, some of these organizations have created funding mechanisms that are designed to discourage "free riders." This usually takes form of **membership dues** or assessments that are mandatory in order for the parent's child to participate in the activity supported by the club (or at least to enjoy the extra benefits provided by the booster club). The mandatory dues requirement is often coupled with an option for parents to satisfy their financial obligation by raising funds from non-parent contributors and having these amounts credited against the parent's obligations under some form of "point" system. It has long been the Service's view that these "pay or do not play" arrangements constitute private inurement and confer substantial private benefit by causing the income and assets of the booster club to benefit primarily the individual parent-members and their children, rather than the broad class of children as a whole.² As another observer put it, "raising money

¹ See Cowen and Sack, "Athlete Booster Clubs: Are They Exempt?" *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1993* (1992) ("CPE Text"), available at www.irs.gov/pubs/irs-tege/eotopica93.pdf.

² *Id.*

for your own kid is not charity.”³ The *Capital Gymnastics* case presented a ripe opportunity for the IRS to reiterate this view.

Paying to play

The Club was organized as a Virginia non-stock corporation in 1987 to “foster national and international sports competition.” In 1988, the IRS recognized the Club as exempt under Section 501(c)(3).

The Club did not train gymnasts. Rather, it operated as a booster club and carried out its exempt purposes almost exclusively by raising funds to provide financial support for amateur gymnasts who trained at Gymnastics National Training Center. The Training Center was a for-profit organization that trained amateur athletes in gymnastics and tumbling, and organized and oversaw competitions.

Each of the families whose children trained at the Training Center paid the Center \$200 to \$330 per month in annual membership fees. These fees, however, were not sufficient to cover the actual costs of participation and, in particular, the costs of meets. To cover the shortfall, the Training Center required the parents of all of its athletes to be members of the Club. In addition to fees paid to the Center, parents were responsible for paying two separate fees to the Club: (1) an annual dues payment of \$40 to defray the Club’s basic operating expenses, and (2) an assessment in an amount varying from \$600 to \$1,400 per year per child to cover each athlete’s cost of participating in competitive events. The Training Center would not permit athletes to compete unless their Club assessment was fully paid.

The Club gave families two options for satisfying their assessment. Parents could simply pay the entire amount in cash or, alternatively, they could voluntarily raise funds to offset the assessment. Fundraising took the form of traditional booster club activities, including the sale of wrapping paper, cookie dough, and “scrip.” The scrip program involved the participation of local businesses that would permit the Club to buy, at a discount, certificates good for purchases at that business. Thus, the Club could buy a certificate with a full face value of \$100 for \$95 and sell the scrip at full face value. When the buyer redeemed the certificate at the business to purchase \$100 worth of merchandise, a fundraising profit of \$5 would be earned for the Club. Most of the scrip was bought by the parents themselves. The willingness of merchants to participate in the scrip program was contingent upon the Club being a tax-exempt, charitable organization.

About half of the parents elected to satisfy at least part of their assessment by fundraising. Each family that chose to raise funds was allocated points by the Club in proportion to the fundraising profit that the family generated. Each point was worth \$10 and was applied to reduce the family’s unpaid assessment in dollars according to the number of points the family had earned. The parents who did not participate in

³ Reilly, “Parent Booster Clubs—Raising Money for Your Own Kid is Not Charity,” Forbes blog on taxes (9/5/13), available at www.forbes.com/sites/petedreilly/2013/09/05/parentbooster-clubs-raising-money-for-your-own-kid-is-not-charity.

fundraising did not receive any benefit from the fundraising activities of the other parents. Those parents wrote checks for their full assessment amounts. Moreover, there was no evidence that monies raised by the sale of scrip or other fundraising activities were used to support “scholarships” or defray the expenses of participation of athletes’ families who may have been unable to afford the costs.

In 2005, the IRS audited the Club’s return for FY 2003. During that year, the families that had participated in fundraising were able to offset their assessments an average of 50% to 70%. Upon completion of its examination, the IRS proposed to revoke the Club’s tax-exempt status. This decision was upheld on administrative appeal, and on 12/1/08, the IRS Office of Appeals issued a final adverse determination letter to the Club. The letter stated the Club had failed to establish that its income “did not inure to the benefit of private individuals and shareholders” and that the organization was operated for a substantial private purpose. As a result, the IRS revoked its recognition of the Club’s tax-exempt status under Section 501(a) beginning with FY 2003. The Club sought a declaratory judgment pursuant to Section 7428 in the Tax Court to reverse the final determination.

Not exclusively

In upholding the revocation of the Club’s tax-exempt status, the Tax Court held that the Club failed the operational prong of the test for qualification under Section 501(c)(3). That prong requires that organizations be “organized and operated exclusively” for religious, charitable, scientific, or other exempt purposes. The court did not dispute that the Club was organized for the permissible tax-exempt purpose of fostering amateur sports competition, but it found that the Club **failed to operate exclusively** for exempt purposes as required by Section 501(c)(3).

An organization operates exclusively for exempt purposes if it serves a public rather than a private interest and **only an insubstantial part** of its activities is not in furtherance of an exempt purpose.⁴ The court concluded that fundraising was the primary activity of the Club and, in allocating its **fundraising profits primarily for the benefit of fundraising parents and their children**, it conferred a substantial and therefore improper benefit on those families. The court reached this conclusion on both private inurement and impermissible private benefit grounds.

Private inurement. The court first focused on the private inurement prohibition, which has its origins in the statutory language that “no part of the net earnings of [the organization may] inure ... to the benefit of any private shareholder or individual.”⁵ The court noted that “private shareholder or individual” is “generally understood to mean an insider of the organization (such as a member or an officer).”⁶ Here, the parties stipulated that the parent-members were “insiders” presumably because they directly or indirectly

⁴ Reg. 1.501(c)(3)-1(d)(1)(ii).

⁵ Capital Gymnastics, TCM 2013-193 at 12 (quoting Section 501(c)(3)).

⁶ *Id.* at 14.

controlled the Club. The court quickly concluded that, because the point system reduced the financial obligation of the parents that raised funds, the organization's income and assets impermissibly inured to the benefit of those parents-insiders.

Private benefit. The court concluded further that, even if the parent-members had not been considered insiders, the Club's operations would have failed the "private benefit" test. The court noted that "[i]mpermissible benefit[s] to 'private interests' . . . encompasses not only benefit to insiders but also benefits that an organization may confer on unrelated or even disinterested persons, i.e., outsiders.⁷ The court's threshold determination was whether there was private benefit regardless of the identities of those served: "even when we determine that the beneficiaries of an organization 'comprise a charitable class: we nonetheless proceed to assure that there is 'no selectivity with regard to the identities of the individual [s] *** to be benefitted.'"⁸

The court acknowledged that the child-athletes at the Club were not insiders and were all members of a charitable class, but concluded that the Club conferred benefits on the child athletes of the fundraising parents only, not the child-athletes as a whole. Addressing whether the benefits provided to the athletes were "substantial; the court noted it had determined that the use of a relatively meager 30% percent of the income of an organization for the benefit of a founder's child constituted a "substantial" benefit in a prior case.⁹ In *Capital Gymnastics*, the Club admitted that a whopping 93% of the fundraising profits were allocated to the accounts of the parent-members who raised funds, thus *directly* and almost exclusively benefiting those parent-members' children. Accordingly, the court concluded that the Club's allocation practice failed the private benefit test.

Fundraising as primary activity. The court acknowledged that fundraising is a permissible activity of a booster club under Section 501(c)(3), even a permissible primary activity. Most booster clubs are formed by parents to support their children in their school or extra-curricular endeavors. One would be hard pressed to find a booster club that does not solicit contributions primarily from parents or endeavor to raise funds in many of the same ways as the Club in *Capital Gymnastics* (e.g., by placing ads in programs, charging fees for concessions or access to events, hosting auctions, candy sales, car washes, etc.)

One problem in this case (and with most booster clubs) was that the Club's heavy emphasis on fundraising heightened the relative importance of its fundraising practices. The Tax Court distinguished the activities of the Club from other organizations (e.g., school bands selling popcorn for new uniforms, church youth groups conducting once-a-year car washes, etc.) in which fundraising represents a smaller fraction of the organization's overall activities. Had the funds raised by the parents in *Capital Gymnastics* represented a smaller proportion of the total revenue of the organization, or

⁷ *Id.* at 14, citing *American Campaign Academy*, 92 TC 1053, 1068-69 (1989).

⁸ *Capital Gymnastics*, *supra* note 5 at 17, fn 8, citing *Aid to Artisans, Inc.*, 71 TC 202, 215-216 (1978).

⁹ *Wendy L. Parker Rehab. Found.*, 52 TCM1986-348.

had the Club engaged to a substantial degree in other exempt activities, the allocation practice might have survived IRS scrutiny. But since the parents' fundraising efforts generated more than 90% of the funds raised by the Club, the court could not deem them insubstantial.

The Club's defenses. In defending its status as an organization entitled to exemption, the Club did not seek to re-characterize its operations. On the contrary, it argued that its operations were not only proper, but that its methods for allocating fundraising profits should be endorsed as a best practice. The Club meticulously maintained individual fundraising accounts to track parent participation and fundraising success. If the parents raised more in a given year than their assessment amount, they received a credit for the following year—but never a refund. Instead of, for example, sharing funds raised in excess of what the fundraiser-parent's child needed among all of the children, the Club required that the extra funds be applied to the fundraiser's child's account.

The Club noted that no cash distributions were ever made to the parent-members, and that the funds raised benefited a “well-defined charitable class” of “school age children competing on the Training Center's amateur teams.”¹⁰ In rejecting these contentions, the court found that the dollar-for-dollar arrangement for crediting the dues accounts of the fundraising parents was tantamount to a “constructive distribution” of cash to the parents, since the credits relieved them of their burden to pay the mandatory assessments that otherwise would be owed. It noted that for purposes of Section 501(c)(3), “benefit” is broadly defined and can include “[a]dvantage; profit; fruit; privilege; gain [or] interest”¹¹ Ultimately, the Club could not overcome the impression (or the reality?) that the efforts of each of its fundraisers to raise money in the name of charity was really just a disguised effort of the parent-member to benefit his or her own child directly. Thus, the court held that the Club's “methodology furthers private interests rather than the team or the organization as a whole, and did not operate consistent with the requirements for exemption.”¹²

The Service's view of booster clubs

The Tax Court decision in this case may have come as a surprise to the Club, but the Service's revocation should not have. As early as 1993, the IRS registered concerns about whether many booster clubs were operating exclusively for exempt purposes and, in particular, whether certain fundraising activities of these clubs give rise to private inurement or confer impermissible private benefit on their members and donors. The IRS signaled its concerns about this issue in the 1993 CPE Text cited above.¹³ The article

¹⁰ Capital Gymnastics, *supra* note 5 at 17-18.

¹¹ *Id.* at 24, quoting Retired Teachers Legal Defense Fund, Inc., 78 TC 280, 286, quoting *Blacks Law Dictionary* 143 (West, 1979).

¹² *Id.* at 19.

¹³ Cowen and Sack, *supra* note 1.

apparently was prompted by the substantial increase in applications received by the Service in the 1980s from gymnastics booster clubs seeking exemption.

The CPE Text noted that, in 1976, Congress amended Section 501(c)(3) to include “foster [ing] national or international amateur sports competitions (but only if no part of the . . . activities involves the provision of athletic facilities or equipment)” as a proper exempt purpose.¹⁴ Citing the legislative history, this article also recognized that appropriate activities of organizations seeking exemption on this basis may include the provision of financial support. Thus, a booster club may qualify under this provision even if the club’s sole activity is raising money and using these funds to support youth sports activities.

The IRS, however, noted that, to qualify for exemption, an organization must operate “exclusively” for exempt purposes. The organization’s exemption will be lost in the presence of a single, substantial non-exempt purpose. The inurement of the organization’s income or assets to insiders or the conferring of more than incidental benefit on unrelated third parties constitutes a substantial non-exempt purpose.

The CPE Text describes, in a “bad” example of a gymnastics booster club that fails to qualify for exemption, hypothetical facts remarkably similar to those in *Capital Gymnastics*. The club in the example was closely associated with a private, for-profit gym that trained amateur gymnasts and organized competitions. Parents of gymnasts who trained at the gym were required to join the booster club, which provided financial support for activities not covered by the fees charged by the gym, including the purchase of athletic equipment and the payment of competition-related expenses. Parents were required either to raise funds or to contribute a corresponding amount of cash sufficient to permit their child to participate in meets and to receive other benefits. Like the Club, the booster club in the example adopted a “point” system in which each gymnast’s family was required to earn fundraising points commensurate with the benefits that family’s child received. A family that failed to earn enough points either had to pay the difference or lose eligibility for distribution of funds raised in the future.

In the CPE Text, the IRS made clear that booster clubs that adopt and enforce these types of policies will likely run afoul of both the private inurement and private benefit prohibitions.¹⁵ The IRS regards parent-members as insiders of a booster club for purposes of the inurement prohibition because, in most instances, they are able to exert direct or indirect control over the club. Because the point system intentionally directs benefits generated by each parent’s fundraising efforts to his or her child, the funds are being used for the benefit of specific individuals rather than the larger charitable class of competitive amateur gymnasts as a whole and inure to the benefit of those parent-members and the child athletes.

¹⁴ *Id.* at 3.

¹⁵ *Id.* at 11.

Analysis

By design, the members of booster clubs are the parents or other family members of the children in the band, on the team, or in the club. These members usually control the organization, at least indirectly. A parent who makes a non-earmarked donation to his or her child's school, or to a booster club that supports an athletic activity in which that child participates, but which does not require fundraising, inevitably confers some benefit on his or her own child. However, if the contribution is not required, or if it is applied equally for the benefit of all children, that benefit will likely be deemed incidental. In contrast, in the case of the club described in the bad example of the CPE Text, and the Club in *Capital Gymnastics*, the mandatory fundraising arrangement amounted to a "cooperative funding mechanism" created by parents to hinder their own children's participation and resulted in more than incidental benefit.

In most nonprofit organizations, it seems, most of the organization's work is done by a few active members, rather than being evenly divided among the whole of the membership. The Club here took great pains to structure its operations so that those who did the fundraising got the credit. The Tax Court seemed to recognize the general fairness of the allocation practice and even made a point to note that the "arrangement that *Capital Gymnastics* developed may well be a rational, wholesome, just, and efficient fundraising method."¹⁶ The court simply found that it furthered a non-exempt purpose and therefore was not appropriate for a charitable organization.

Most advisors who provide guidance to booster clubs, such as the organization Parent Booster USA, strongly discourage the use of individual fundraising accounts, but are there circumstances in which their use may be appropriate and consistent with tax exemption? Notably, the IRS has stopped short of explicitly prohibiting individual fundraising accounts for booster clubs and other organizations. It is clearly the Service's view that booster clubs should support all of their athletes, band members, etc., to the full extent of their resources, regardless of whether the parents are members or contributors. There may be wiggle room, though, because an "insubstantial" amount of private benefit is permissible. Query, for example, how the Tax Court would have ruled if the allocations to the individual fundraising accounts had constituted only 20% rather than 90% of the funds raised? What would have been the outcome if the Club had offered even partial scholarships and made its dues recommended rather than mandatory?

Conclusion

It is likely that the operations of many booster clubs could raise the same questions about private inurement and private benefit. Regrettably, *Capital Gymnastics* did not provide many new insights beyond the views previously expressed by the IRS—in part, because the facts of this case so closely tracked the facts of the "bad example" in the CPE Text. It is unfortunate that the Tax Court was not forced to address some of the legal gray areas about the extent to which individual fundraising accounts could be employed as well as other unanswered questions that concern these kinds of

¹⁶ *Capital Gymnastics*, *supra* note 5 at 25.

organizations. The result in *Capital Gymnastics* was neither surprising nor a close call. In the end, the Club's rigorous point allocation system, which favored some child athletes over others, was fatal to its tax exempt status. It allocated almost all of its fundraising revenue to the fundraising parents. Had the Club been less focused on discouraging "freeloaders" and "moochers," and more focused on its mission to support and develop the child-athletes, it might have retained its exemption.