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Private Benefit Rules – Part II: Private Inurement Doctrine

By Emily Chan (http://www.nonprofitlawblog.com/author/emily-chan/) on October 16, 2012

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(http://www.nonprofitlawblog.com/assets/6a00d834558ca469e2017c32920493970b-pi)The private inurement doctrine is another private benefit rule applicable to public charities. The doctrine comes directly from the language of section 501 of the Internal Revenue Code that only organizations “no part of the net earnings of which inures to the benefit of any private shareholder or individual” may

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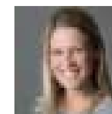

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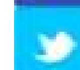
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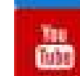
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be exempt under section 501(c)(3). A 501(c)(3) organization that violates the private inurement doctrine fails to be operated exclusively for one or more exempt purposes and is subject to revocation of its exempt status. (See Treas. Reg. Section 1.501(c)(3)-1(c)(2)).

There is no strict definition for "inure" but this is generally understood as providing unjust enrichment from the organization's gross or net earnings to another party. (See People of God Community v. Commissioner, 75 T.C. 127 (1980)). Unlike the private benefit doctrine discussed in Part I (http://www.nonprofitlawblog.com/home/2012/09/private-benefit-rules-part-i-private-benefit-doctrine.html), the restriction on inurement is absolute (i.e., the doctrine does not allow for incidental private inurement). Additionally, the private inurement doctrine is narrower in reach than the private benefit doctrine, which can apply to any person. "Private shareholder or individual" is defined in the Treasury Regulations as "persons having a personal and private interest in the activities of the organization." (See Treas. Reg. Section 1.501(a)-1(c)). In other words, the private inurement doctrine generally applies to persons, commonly referred to as "insiders," who are in a position to influence or control use of the organization's assets for personal gain such as founders, directors, or officers.

It is important for public charities to understand the private inurement doctrine does not bar the organization from entering into transactions with insiders. The private inurement doctrine does however bar the organization from providing a disproportionate share of benefits to an insider regardless of whether the inurement conferred is $1 or $1,000.

Private inurement violations may be found in situations involving:

- A compensation arrangement with an insider where there is no upper limit (see People of God Community);
- A compensation arrangement that is based on factors extrinsic to performance at and benefit to the organization (see G.C.M. 39498);
- Use of gross or net earnings to provide goods and services to insiders; or
- Paying more than fair market value in exchange for goods or services provided by an insider.

Organizations should also be wary of the certain transactions that due to their complexity, unfamiliarity, or other circumstances, can be more difficult to analyze and may result in private inurement violations for unwary or uninformed organizations, such as:

- Assignment of rights to intellectual property developed by insiders and funded, in whole or in part, with organizational assets;
- Compensation arrangements with added considerations such as deferred compensation, bonuses, fringe benefits, or retirement or severance packages; or
- Use of organizational assets to support, fund, or otherwise invest in an insider's business.

Boards of directors should furthermore be cautious of poor governance practices that can exacerbate the likelihood of private inurement violations under their oversight, such as:

- A failure to acquire sufficient information to allow for thorough board discussion and informed decisions prior to board approval;
- A limited understanding about the fiduciary duties of care and loyalty;
- The absence of a conflict of interest policy; and
- A lack of knowledge about applicable state laws that may place additional restrictions or procedural requirements on transactions with insiders.

The private inurement doctrine is often overlooked because of its overlap with the private benefit doctrine which subsumes the private inurement doctrine. Additionally, the penalty of revocation has historically not been enforced except in egregious cases. However, regardless of whether an organization would face such a severe penalty at the hands of the IRS, the private inurement doctrine is a cornerstone principle that all public charities should understand.

*Please note 501(c)(3) private foundations are subject to self-dealing rules under Internal Revenue Code section 4941 which generally prohibits private foundations from engaging in transactions with certain *disqualified persons*.

For more information on the private inurement doctrine and private benefit issues, please read the IRS Exempt Organizations internal document "Overview of Inurement/Private Benefit Issues in IRC

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501(c)(3) (http://www.irs.gov/pub/irs-tege/eotopicc90.pdf).”

Part I discusses the private benefit doctrine and is available here (http://www.nonprofitlawblog.com /home/2012/09/private-benefit-rules-part-i-private-benefit-doctrine.html).

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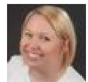

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