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## NONPROFIT ORGANIZATIONS LAW

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Here is some information on the issues of private benefit and inurement facing nonprofit organizations. Such issues include distinguishing private inurement from private benefit and distinguishing permissible and impermissible private benefit.

#### PRIVATE INUREMENT

Private inurement is an insider<sup>1</sup> benefit. It arises when an insider in the organization receives a benefit from the organization on the basis of the insider's relationship to the corporation. Where an insider receives a benefit from the corporation in the capacity of a community member, rather than as an insider, the benefit will not constitute inurement provided the benefit is incidental to achieving the organization's exempt purpose. Any transaction between an insider and the organization discovered in an audit will trigger a more in-depth review of the organization's activities to determine whether private inurement exists. To overcome the suspicion of inurement, the organization will need to show that the transaction was reasonable and fair to the organization. For most transactions, if the organization can show that the transaction was negotiated at arm's length and was in the best interests of the organization, inurement will not be found. In cases of excessive compensation, the reasonableness standard is "only such amount as would ordinarily be paid for like services by like enterprises under like circumstances." Treas. Reg. § 1.162-7(3).

In Wendy L. Parker Rehabilitation Foundation v. C.I.R., TC Memo 1986-348, the IRS held that an organization formed to aid coma victims, one of whom was family of the founder, would violate the prohibition of private inurement by spending 30% of the foundation's funds on the founder's family member.

In People of God Community v. Comm'r, CITE, the pastor was given a percentage interest in the income of the church without a specified upper limit. The result was that the church income was being passed on to the pastor in the form of an unreasonable salary, thereby resulting in inurement.

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<sup>1</sup> A person with a personal and private interest in the payor organization. IRS 1990 CPE - C.

### PRIVATE BENEFIT

Unlike private inurement, private benefit includes people that are not insiders of the organization, and may be considered a permissible benefit. Private benefits may be considered permissible where the benefit is incidental and unsubstantial. However, the IRS does not define incidental or unsubstantial, and often uses incidental as a qualitative and quantitative measure. In the IRS CPE of 1981, the IRS explains the procedure for determining whether a private interest is more than incidental. This determination turns on “the nature and quantum of the activity under consideration and the manner by which the public benefit will be derived.” Private benefit must be incidental in both nature and quantity, and acceptable benefit varies from case to case, in direct relation to the degree of public benefit derived.

In determining whether a private benefit is permissible, we may look to the four factors the court considered in Contracting Plumbers Cooperative Restoration Corp. v. U.S., 488 F.2D 684, which were: 1) the formative history of the organization, 2) the interests provided by the bylaws, 3) the actual operation of the organization, and 4) the availability of the benefit to the public. Contacting Plumbers involved a cooperative formed by plumbers, the purpose of which was to repair the “cuts” in the road that resulted from their plumbing work. 1) The organization was formed to benefit the plumbers by repairing, at a reduced rate, damage for which they are liable. 2) The bylaws of the organization expressly stated this interest. 3) The organization’s operations were limited to repairs for which the members were liable only. And 4) the members of the cooperation benefitted economically from the service to precisely the degree in which they used and paid for the service. All together, the court determined that the public benefit of the repaired roads was overshadowed by the private benefit to the participating plumbers, and the organization was therefore not an exempt organization. This case demonstrates how fact-specific private benefit analysis is.

In determining private benefit, the court and the IRS consider the character of the transaction and the parties involved. Where there is a legitimate public benefit, the task is to define the degree to which one may receive a private benefit before it becomes impermissible. The character of the beneficiary of the benefit, the character of the benefit, and the character of the organization are all factors considered in the determination. C.I.R. v. Forest Lake, Inc. The character of the beneficiary refers to the role the beneficiary is in when the benefit occurs. The character of the benefit refers both to the public or private character, as well as to the incidental and unsubstantial nature of the benefit. The character of the organization refers to whether the organization has a charitable purpose that directs its actions.

In 501(c)(4) organizations, the issue of private benefit also arises, and the courts and IRS seem to have some difficulty agreeing on the permissible amount of public

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benefit for such organizations. The court has historically taken a broader view of permissibility. In comparing some of the courts and Internal Revenue Service opinions on the matter, the issue becomes clearly about the how the beneficiaries are limited, rather than how many beneficiaries are included.

In Monterey Public Parking Corporation v. U.S., the court upholds a decision that an organization formed to provide a downtown parking area was an exempt organization, despite reducing the cost of parking for validated slips. The IRS argued that the benefit to the businesses in the area outweighed the public benefit of available parking. However, in Rev. Rul. 78-86 the IRS directly expresses disagreement with the court. Similarly, Eden Hall Farm v. U.S. affirms the exemption of an organization that provided recreational facilities to the employees of selected corporations and the IRS responds with Rev. Rul. 80-205 expressly stating its intention not to follow.

The difficulty of defining private benefit is 501(c)(4) organizations is similar to that in 501(c)(3) organizations, in that there is no established ratios practitioners may rely on. Instead, the analysis is highly focused on the specific facts of each case, the character of the organization and its activities, the character of the benefit, and the character of the beneficiary.

## PROBLEM PROVISIONS FOR PRIVATE INUREMENT?

### Facts:

- Contract with a private company to provide accounting, accounts payable, payroll processing, tax reporting, and data base management.
- Contract term is 20 years
- Contract can be terminated by either party upon material breach
- Contract can be terminated every 10 years by the private company if it determines it is not making a reasonable profit.
- Fee is a fixed percentage of net revenues, including donations. (This protects the nonprofit if donations drop).
- Fee is re-negotiated every other year. If the parties can't reach agreement, the prior years' fee remains in place.

Assuming that the fee is equivalent to fair market value for the services, are the terms themselves so unfair that there is private inurement?

How is it best to determine if the fee is in fact equivalent to fair market value, since the bundling of all of these services in a single business is unusual?