



This article presents general guidelines for Georgia nonprofit organizations and should not be construed as legal advice. Always consult an attorney to address your particular situation.

Private Inurement

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This article will: (1) explain why those involved with section 501(c)(3) organizations need to be familiar with the restriction against private inurement; (2) discuss the definition of private inurement; (3) provide examples of private inurement; and (4) provide suggestions that you may follow to help protect your 501(c)(3) organization against private inurement.

Why Private Inurement Matters To Nonprofits

Private inurement is one of the most fundamental and critical concepts to understand for those working with section 501(c)(3) organizations. It is important to be familiar with this concept because the IRS may revoke an organization's tax exemption if it finds the presence of private inurement.

What is Private Inurement?

By providing section 501(c)(3) organizations with exemptions from federal income taxes, Congress is essentially providing a subsidy to these types of organizations. Because Congress provides substantial financial benefits to 501(c)(3) organizations, Congress wants to ensure that people who work with a charity do not take any of the charity's income or assets for their personal use. Therefore, Congress inserted a provision in the Internal Revenue Code to prevent this from happening. Essentially, the restrictions on private inurement and private benefit serve to prohibit persons from "taking advantage" of an organization's tax exemption for personal gain.

The private inurement restriction generally only applies to persons who have a level of control over the organization that is comparable to that of a corporate insider. Thus, the relationship of an individual to the exempt organization will determine whether the potential for prohibited private inurement exists. Certain individuals, by virtue of their control over the organization, have the ability to take advantage of an organization's exempt status by approving transactions that are more favorable to them than to the organization. Some examples of individuals who are commonly found to have this level of control include:

- Executive Directors and CEOs
- CFOs
- Vice Presidents
- Managers
- Members of the Board of Directors

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Although the application of the private inurement doctrine is generally limited to transactions with individuals who have a certain level of control over the organization, even a small amount of undue benefit flowing to such persons can result in revocation of the organization's tax exempt status.

Examples of Private Inurement

There are many ways in which individuals in control of an organization's activities may take advantage of the organization. Some examples of private inurement transactions may include:

- Paying excessive compensation to the organization's Executive Director.
- Paying above-market rent for a building owned by the organization's CEO.
- Leasing office space to a Director at below-market rates.
- Hiring a lawyer to provide legal services at a rate that is greater than his or her standard hourly rate when the lawyer is related to a Board member.
- Buying property from the organization's Vice President for an amount greater than the property's fair market value.

One of the most common forms of private inurement is excessive compensation. As a result, the IRS often analyzes compensation for potential private inurement. The IRS particularly frowns upon compensation arrangements that include a bonus tied to revenues or fundraising or any type of revenue-sharing arrangement. When analyzing compensation, the IRS will consider all types of compensation, including:

- Fringe benefits, such as gym memberships and cell phones
- Bonuses
- Low-interest or interest-free loans
- Personal use of the organization's facilities or property at low or no charge
- Housing provided at below market rent
- Insurance premiums paid on behalf of the employee
- Contributions to retirement plans

How to Protect Your Nonprofit From Private Inurement

An organization can take certain precautions to help ensure that transactions do not result in private inurement. One precaution taken by many tax exempt organizations is to adopt a Conflicts of Interest Policy. This type of Policy includes safeguards to help ensure that if the organization enters into a transaction with an insider, the transaction will be on fair and reasonable terms. Aside from a Conflicts of Interest Policy, there are other precautions an organization can take to help prevent private inurement, including the following:

- Examine compensation arrangements on an annual basis to make sure the terms are reasonable.

- Obtain compensation information from organizations that are similar in size and conduct similar activities to see if the amounts they pay in compensation are similar.
- Place a cap on the total amount of compensation that can be paid to any one individual.
- Avoid commissions or compensation tied to revenues or fundraising.
- Obtain the assistance of legal counsel to negotiate compensation agreements and, if possible, have the organization and the employee represented by separate attorneys.

With proper safeguards in place, a 501(c)(3) organization can help ensure that private inurement is avoided and that the organization's tax exemption is preserved. If you would like more information on private inurement, you can find additional information on the IRS's website at www.irs.gov.