The Private Inurement Prohibition, Excess Compensation, Intermediate Sanctions, and the IRS's Rebuttable Presumption

A Basic Primer for 501(c)(3) Public Charities

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Note: These materials are intended to provide only a general summary and overview of these topics as they pertain to public charities that have been granted tax-exempt status under section 501(c)(3) of the Internal Revenue Code. They do not address the applicability of these topics to other types of tax-exempt organizations, such as private foundations and those that have been granted tax-exempt status under other parts of section 501(c) of the Internal Revenue Code. These materials are not to be considered legal advice applicable to any particular situation, and organizations and individuals needing specific advice and counsel on these matters should always consult with knowledgeable counsel.

I. THE PRIVATE INUREMENT PROHIBITION

The private inurement prohibition requires that a public charity that has been granted tax-exempt status under section 501(c)(3) of the Internal Revenue Code ("charity") operate so that none of its income or assets unreasonably benefits any of its board members, trustees, officers, or key employees. These types of individuals are commonly referred to as "insiders." Thus, the prohibition precludes any of the income or assets of a charity from unfairly or unreasonably benefiting, either directly or indirectly, individuals who have close relationships with their organizations and the ability to exercise control over them.

The most common type of private inurement is excessive compensation paid to insiders and is discussed in Section II below. There are, however, many other forms of private inurement that can also result in the revocation of a charity's tax-exempt status and/or in the imposition of significant "intermediate sanctions," discussed in Section III below. These other forms of possible private inurement include, but are not limited to, transactions such as:

- the sale of a charity's asset to an insider;
- the charity's purchase of an asset from an insider;
- the charity's rental of property from, or to, an insider;
- the charity's lending of money to an insider; and
- the use of facilities and/or other assets of the charity by an insider.

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Just as with assessing the appropriateness of an insider's compensation, the decisive factor in determining whether a transaction with an insider violates the private inurement prohibition is whether the transaction is fair and reasonable under the circumstances. For example, it would not necessarily be improper to sell a charity's asset to an insider at, or above, its fair market value, but it might very well be improper to sell a charity's asset to an insider for less than its fair market value. Similarly, it would not necessarily be improper to rent a charity's office facilities from an insider at, or below, fair market value, but it would be improper to do so for more than fair market value. Likewise, it would not necessarily be improper for a charity to purchase assets and/or services from an insider, or from an entity with which the insider or a family member of the insider is affiliated, as long as the assets and/or services are purchased at, or below, their fair market value rather than for more than their fair market value.

The courts and the IRS have consistently ruled that any unreasonable benefit or inurement, however small, is impermissible and can result in the revocation of a charity's tax-exempt status. Even, however, if private inurement is clearly present in a particular fact situation, it can often be argued that the ultimate sanction of revoking a charity's tax-exempt status should not be imposed if the unreasonable benefit received by an insider was only incidental or insignificant. In these instances, a strong case can be made to have only the "intermediate sanctions" discussed in Section III below imposed instead.

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II. EXCESSIVE COMPENSATION

As was noted earlier, the most common type of private inurement is the payment of excessive compensation to insiders. The IRS has significantly increased its enforcement efforts in this area and recently assessed millions of dollars in penalties for these types of violations. In addition, the IRS has indicated that it will now include excess compensation analyses in every future audit it conducts. It is important to note, however, that individuals working for a charity are not required to donate their services and are allowed to be reasonably compensated. They are not required to work for free or accept reduced compensation simply because they provide their services to a charity rather than to a taxable organization, although such individuals often do. The private inurement prohibition simply requires that the total compensation paid by a charity to an insider be fair and reasonable.

Whether an insider's total compensation is fair and reasonable is determined on a case-by-case basis using a process similar to that used to value anything; this process requires a charity to gather comparable data regarding what similarly situated individuals running similar organizations are paid. There are numerous sources for obtaining this information. For example, ERI Economic Research Institute, **www.erieri.com,** and GuideStar, **www.guidestar.org,** are two excellent sources.

For an insider's compensation to be fair and reasonable, there must be an approximately equal exchange of benefits between the charity and the insider so that the insider does not receive an unreasonable or unwarranted benefit from the charity. Nonprofit law expert Bruce R. Hopkins notes on page 571 of his comprehensive treatise, *The Law of Tax-Exempt Organizations,* ninth edition, several factors commonly considered to evaluate the reasonableness of an insider's compensation, including:

- the compensation paid by similar organizations, both exempt and taxable, for equivalent positions in the same community or geographic area;
- the charity's need for the particular services of the person in question;

- the uniqueness of the person's background, education, training, experience, and responsibilities;
- whether the compensation was approved by an independent board of directors;
- the size and complexity of the charity's income and assets and the number of employees the charity has;
- the person's prior compensation arrangements;
- the person's job performance;
- the relationship of the person's compensation to the compensation paid to the charity's other employees; and
- the number of hours the person spends performing his or her job.

Total compensation paid by a charity to an insider includes more than just the insider's salary or wages. It includes all other forms of compensation the insider receives, such as bonuses, commissions, royalties, fringe benefits, deferred compensation, severance payments, retirement and pension benefits, expense allowance, and insurance benefits.

The bottom line is that an unreasonably large or excessive salary paid by a charity to an insider can be considered private inurement, especially when the insider also receives other forms of compensation from the charity. It is important to note, however, that very large salaries and non-cash benefits paid to certain key employees can often be reasonable when one considers the employee's experience and expertise. For example, highly skilled and experienced physicians at a nonprofit hospital are sometimes paid significantly more than the hospital's CEO and other executive-level staff.

Mr. Hopkins notes on page 577 of his treatise that a charity can avoid violating the private inurement prohibition for compensation it pays to an insider as long as it is able to:

- describe fully and accurately all aspects of the insider's total compensation package;
- explain exactly how the charity determined the insider's total compensation package;
- describe adequately and accurately the insider's duties and responsibilities;
- provide adequate documentation, such as comparable salaries paid by similar organizations, that show the reasonableness of the insider's compensation;
- show through appropriate documentation that the charity's governing body approved the amount of the insider's compensation and that the insider or someone related to the insider did not participate in the process;
- show that the amount of the insider's total reportable compensation agrees with the amount reported on the insider's Form W-2 or Form 1099 to avoid an automatic excess benefit transaction; and
- show through appropriate documentation that the insider's use of any of the charity's assets, such as a cars, real estate, credit cards, laptops, or cell phones, for other than fulfilling the charity's exempt purposes, were properly included in his or her compensation and properly included in the insider's Form W-2 or Form 1099, again, in order

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to avoid penalties for automatic excess benefit transactions.

III. INTERMEDIATE SANCTIONS

As was noted in Section I above, not all findings of private inurement will result in revocation of a charity's tax-exempt status. Section 4958 of the Internal Revenue Code provides for "intermediate sanctions" that allow the IRS to impose significant taxes on insiders, whom the applicable regulations refer to as "disqualified persons," when they engage in excess benefit transactions with a charity. Therefore, section 4958 gives the IRS the authority to impose a sanction short of revocation when revocation would be inappropriate and/or unnecessarily harsh.

In an excessive compensation case, the "excess benefit" is the amount by which the total compensation paid by the charity to an insider exceeds the reasonable value of the services provided by the insider to the charity. So, for example, if a comparison of relevant salaries shows that an insider is being paid $100,000 more than comparable individuals performing similar functions at similar organizations and that there is no legitimate reason for doing so, the amount of the "excess benefit" received by the insider would be $100,000.
Section 4958(a)(1) of the Internal Revenue Code imposes an initial tax equal to 25 percent of the excess benefit. The insider in this example would have to pay a $25,000 penalty to the IRS as well as make the charity whole by repaying the $100,000, plus interest.

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If the insider does not make the charity whole within the time frame set by the IRS, section 4958(b) of the Internal Revenue Code imposes an additional tax equal to 200 percent of the excess benefit on the insider—an additional $200,000 penalty in the current example.

Section 4958(a)(2) of the Internal Revenue Code also imposes a tax equal to 10 percent of the excess benefit on any charity manager, typically a board member, who knowingly approved the excess benefit transaction, unless his or her participation was not willful. Again, in the above example, the tax on any board member who knowingly approved the unreasonable or excessive salary would be $10,000.

It is important to note that participation includes a board member's silence or inaction where he or she is under a duty to speak or act as well as any affirmative action by the board member. A board member is not considered to have participated in an excess benefit transaction, however, if he or she opposed the transaction by, for example, having his or her objection to the transaction noted in the charity's board meeting minutes. In addition, a board member's participation will not normally be considered to have been knowing within the meaning of section 4958(a)(2) if there was full disclosure of all relevant facts to an appropriately qualified professional and the board member relied on a reasoned written opinion of that professional that the transaction in question was reasonable.

IV. THE IRS's REBUTTABLE PRESUMPTION

To help charities comply with this sometimes complex area of the law, the IRS has established a "rebuttable presumption" that payments to insiders are presumed to be reasonable and not excessive if the following steps were taken:

- the charity's board obtained and relied on appropriate comparability data prior to making its determination;
- the total compensation package was approved in advance by the charity's board, and no individuals who had an actual or potential conflict of interest with respect to the compensation arrangement participated in the deliberations; and
- the charity's board adequately and contemporaneously documented the basis for its determination.

If the above three steps were taken, the IRS may only rebut the presumption of reasonableness if it can show that the comparability data relied on by the charity's board was inappropriate. For charities with annual gross receipts of less than $1 million, a board is considered to have had appropriate comparability data if it had data on compensation paid by three comparable organizations in the same or similar communities for similar services.

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V. CONCLUSION

In this age of significantly heightened scrutiny of the charitable sector by state and federal regulators, Congress, the media, and donors, it is especially critical that a charity take all necessary steps to ensure that it doesn't violate the private inurement prohibition by paying one or more of its officers or employees excessive compensation. Not to do so can jeopardize the charity's tax-exempt status and/or result in the imposition of significant financial penalties against those determined to have been excessively compensated as well as against those who knowingly approved the excessive compensation.

Given the fact that the IRS has significantly increased its enforcement efforts in this area and recently assessed millions of dollars in penalties for these types of violations—and has indicated that it will be routinely including excess compensation analyses in every future audit it conducts—a charity that fails to follow the basic steps suggested by the IRS to ensure that the compensation it pays insiders is reasonable and not excessive is acting irresponsibly, and its directors may not be properly exercising their fiduciary responsibilities. In addition, a charity's failure to follow these basic steps for determining compensation for insiders will now be public information because, starting in 2008, a charity must indicate on its annual IRS Form 990 return whether it followed these steps in determining the compensation of its insiders and other employees. Consequently, a charity will want to consider carefully how it answers these questions.

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