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Introduction to Private Inurement and Private Benefit for Religious Nonprofit Leaders

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Executive Summary

- Religious organizations must comply with federal tax laws prohibiting the use of a tax-exempt organization for the benefit of a private individual.
- The Internal Revenue Code (the "Code" or "IRC") has an absolute prohibition against private inurement, which refers to transactions through which an insider gains financial advantage from a tax-exempt organization's assets.
- The Code limits private benefit, financial or otherwise, to any individual, whether an insider or outside party, to benefits which are incidental to the tax-exempt organization's activities.
- Organizations considering transactions with interested parties should conduct careful due diligence and document their choice and its basis.
- Consequences for violations of the prohibition and the restriction include fines and loss of tax-exempt status, as well as considerable reputational harm.
- Compliance and the related documentation are particularly important for organizations which are exempt from filing the IRS Form 990 because the IRS can investigate the operations of such organizations at any time, even if years have passed since the alleged misconduct.
- To understand how the general concepts in this whitepaper apply to your organization, you should consult with an attorney who is licensed in your state and familiar with nonprofit corporate and tax law.

Introduction

Increasingly, the daily headlines feature allegations of misconduct by the leaders of churches and religious tax-exempt organizations.[2] Typical stories describe an insider's use of the tax-exempt organizations' assets, such as a private plane, funds, or business opportunities, for the benefit of the insider or a favored person. Even if misconduct allegations are later shown to be unfounded, such stories can permanently harm an organization and, perhaps worse, the people it serves. Trustworthiness in fact and appearance is critical for religious organizations, especially if they are donor funded.

To avoid misconduct and related allegations, religious organization leaders must not only understand the moral difference between "right" and "wrong" but also the differences between "right" or "wrong" from a federal tax perspective.[3]

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[2] For ease of reading, this paper will use the term "religious organizations" to refer to churches and other religious tax-exempt organizations.
[3] Tax-exempt organizations are also subject to state laws related to conflicts of interest and the use of charitable assets. This aspect of tax-exempt organization management will be addressed in a separate whitepaper.

These distinctions are particularly important in the context of the IRS prohibitions on private inurement and improper private benefit.

This paper will provide the legal background of the issues of private inurement and improper private benefit, the consequences of violations, examples of situations when potential violations might arise, and practical steps religious organization leaders can take to achieve compliance in fact and appearance.

Background: The Scope of "Exempt" Status

Religious organizations often receive exemptions from federal income tax and from certain federal tax registration and reporting requirements, such as the annual IRS Form 990 filing.

Because of these exemptions, or due to a mistaken understanding of the meaning of "separation of church and state," religious organization leaders sometimes do not realize the organization has other significant tax compliance responsibilities which the organization must discharge to continue enjoying tax exemption.

An Overview of Improper Private Benefit and Private Inurement

THE CONCEPTS

Among the tax laws applicable to religious organizations are specific laws that prohibit private individuals from improperly benefiting from the religious organization's operations. The key principles behind these laws are: (1) insiders[4] should not receive financial advantages from the religious organization's earnings; and (2) the religious organization's operations must be always be primarily in furtherance of its exempt purposes.

IN DEPTH - PRIVATE INUREMENT

Religious organizations are absolutely prohibited from engaging in private inurement, which means that the leaders of an exempt organization cannot gain financial advantages from the tax-exempt organization's revenue and assets. [5]

In the words of the tax code, for an organization to obtain or maintain exempt status, "no part of the net earnings can inure to the benefit of any private shareholder or individual." [6] A "private shareholder or individual" is defined as any person having a personal and private interest in the organization's activities.[7] The regulations make it clear that private individuals in control of the organization are prohibited from personal financial or material gain at the expense of the tax-exempt organization.

It is important to note that private inurement does not occur in situations in which the tax-exempt organization bargains to receive a necessary service or product and in exchange compensates an individual with a fair amount. As discussed below, assessing fair value objectively, and documenting the results of the assessment, is an important best practice for religious organizations.

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[4] "Insiders" here refers to "any person having a personal and private interest in (an) organization's activities." Treas. Reg. § 1.501(a)-1(c).
[5] IRC § 501(c)(3).
[6] IRC § 501(c)(3).
[7] Treas. Reg. § 1.501(a)-1(c).

Private inurement in any amount is absolutely prohibited. Violations of this prohibition may cause the tax-exempt organization to lose its tax-exempt status. The next whitepaper in this series will discuss the consequences of violations in more depth. [8]

In Depth – Improper Private Benefit

Relatedly, religious organizations must stay focused on their mission. The presence of a single substantial non-exempt purpose destroys the organization's eligibility for tax-exemption, regardless of the number or importance of the exempt purposes. [9] This means that any benefit to a private individual must be simply a secondary consequence of the organization's exempt activities.

In the words of the tax code, "Thus, … it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests."[10]

The concept of improper private benefit is different from, but related to, the issue of private inurement. The restriction on improper private benefit extends to all private individuals, not only interested persons, and it extends to various types of benefits, not only financial advantage.

An IRS ruling from 1976 provides a practical illustration of the importance of the difference between private inurement and improper private benefit.[11] The ruling described how several individuals passionate about classical music formed an organization to encourage public appreciation of classical music. To this end, the organization hosted a campaign to increase listenership for a classical radio program on a local commercial radio station. None of the individual founders gained financially from the organization's activities, so there was no private inurement. However, the IRS found that the organization's activities created substantial benefit to the local, private commercial radio station. The IRS concluded that the organization was not tax-exempt because it was operating partly for exempt purposes but partly for the benefit of the private radio station.

Incidental Private Benefit

Private inurement is prohibited, but not all private benefit is impermissible. If a person receives an incidental economic benefit from a tax-exempt organization, such incidental benefit generally will not violate the IRS restrictions on private benefits.

Examples of acceptable private benefit are a person in need receiving soup at a homeless shelter and a vendor receiving reasonable compensation for his or her services. Both are private individuals and both have received a benefit. The benefits are not improper however, because they are incidental to the tax-exempt operations of the organization.

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[8] IRC § 501(c)(3).
[9] Treas. Reg. § 1.501(c)(3)-1(c)(1).
[10] Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).
[11] Rev. Rul. 76-206, 1976-1 C.B. 154.

The IRS decides whether a private benefit is incidental to the tax-exempt purposes of an organization by considering the nature and amount of the private benefit, which the IRS calls the "qualitative" and "quantitative" aspects of private benefit.[12]

If a private benefit is a "mere byproduct" of the public benefit, the private benefit is qualitatively incidental. In the example of the soup kitchen, the benefit to any one specific person receiving soup is a mere byproduct of the soup kitchen's service to all persons in need.

If a private benefit is insubstantial in amount, it is quantitatively incidental. Continuing the example of the vendor, if a tax-exempt organization spends less than one percent of its revenue on services from that vendor, the benefit is likely quantitatively incidental. On the other extreme, if more than fifty percent of revenue is spent on services from a single vendor, the private benefit is almost certainly quantitatively substantial, not incidental.

Situations Where Private Inurement and Impermissible Private Benefit May Occur

Although there are, unfortunately, quite a few modern examples of extravagance, and even criminal conduct, related to misuse of tax-exempt organization resources, most religious organization leaders seek to comply with the tax law.

However, beyond the clear-cut cases of private jets and lavish vacations, private inurement and impermissible private benefit issues sometimes come "in sheep's clothing," through seemingly unimportant, practical aspects of nonprofit operations. Examples include compensation, rent, service contracts, and loans. Because nonprofit leaders often have close friendships or family connections with the organizations they lead, it may seem unnatural to them to negotiate at arm's length or to withhold seemingly innocent "perks" from friends and family.

Some examples of transactions which likely violate federal tax law prohibiting private inurement and private benefit are:

- Excessive payments by a tax-exempt organization for goods, services, or property;
- Excessive compensation payments made by a tax-exempt organization to its top management;
- Excessive payments by a tax-exempt organization to rent property;
- Rent of a tax-exempt organization's property at less than fair market value to others;
- Loan to a tax-exempt organization at higher than the market rate of interest;
- Loan by a tax-exempt organization to others at lower than the market rate of interest or without adequate security;
- Any transaction involving a diversion of a tax-exempt organization's assets; and
- The sale of a tax-exempt organization's asset in exchange for a payment less than the fair market value of the asset.

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[12] *Private Benefit Under IRC 501(c)(3)*, IRS EO CPE Text 135-153 (2001), *available at* https://www.irs.gov/pub/irs-tege/eotopich01.pdf.

The Consequences

Understanding these concepts is critical because violations have harsh consequences. Specifically, if a private individual benefits improperly from the operations of a religious organization, the IRS may:

- Revoke the organization's tax-exempt status, if warranted;
- Impose an excise tax up to 25% of the amount involved to be paid by the individuals that personally benefited;
- Impose an excise tax up to 200% of the amount involved to be paid by the individuals that personally benefited, if they have not timely corrected their excess benefit;
- Impose an excise tax up to 10% of the amount involved with a cap at $20,000 on the organization managers that approved the transaction; or
- Do all of the above.

For religious organizations exempt from filing the IRS Form 990, the risks of noncompliance in this area are higher than for other groups. This is because, for IRS Form 990-nonfilers, the government, or another appropriate party, can investigate and bring a lawsuit based on financial misconduct at almost any time, even if years have passed since the alleged misconduct.[13] The Catholic Church leadership—cardinals, archbishops, bishops, parish priests, etc., should be aware of this potential exposure and gravely concerned in light of the recent willingness of officials to investigate the church.

General Best Practices[14]

1. **Education.** Leaders of religious organizations should educate the organization's directors, finance council, officers, and employees about these concepts, the consequences of violations, and the importance of compliance. This can be done by distributing this article or a similar article describing the basics of private inurement and impermissible private benefit.

2. **Prevention.** Religious organizations should have a conflict of interest policy, which directors, officers, and key employees should review and sign annually. The policy should set forth protocol for board review of any transaction that may involve a benefit to an interested person. The IRS publishes an example policy, which can be adapted to fit a religious organization's needs.

   The board of directors should also draft a list of transactions which require the pre-approval of the board, to avoid violations or the appearance of violations. The list should address the organization's

[13] This is a simplified description of the concept of the tolling of the statute of limitations. In most federal tax contexts, the statute of limitations for misconduct begins tolling on the date of the filings of a tax return. Generally speaking, for organizations which do not file, the statute of limitations does not have a start date, so investigations can be conducted at any time, even years after the events occurred. See this article for more detail https://www.americanbar.org/groups/business_law/publications/blt/2017/08/06_wood/.

[14] This list contains general best practices related to the concepts in this whitepaper. To understand how the best practices and the general concepts in this whitepaper apply to your organization, you should consult with an attorney who is licensed in your state and familiar with nonprofit corporate and tax law.

typical operations. Some examples might include contracts with an interested person and contracts above a certain threshold of value; loans; compensation; and rental contracts.

3. **Diligence.** When making decisions, particularly those involving an interested person, the board should conduct its due diligence to determine what options are available and what options would best serve the organization. For example, when considering hiring a construction firm to renovate a facility, the board should solicit quotes from several firms. The board is not obligated to choose the least expensive option; but the board should make a choice which is fair, reasonable, and in the best interests of the organization. The board should also describe, in writing, what factors led to its choice of one contractor over another.

   In the context of transactions which are particularly high value or high profile, the leadership should consider having an outside opinion, such as from a law firm, consulting firm, or accountant, to assess the available options and make recommendations to the board

4. **Documentation.** For decisions involving interested persons, as well as any other key financial decisions, the board should document its diligence in a written resolution indicating the background and research done, the board's reasoning, and the board's conclusion. The resolution need not be exhaustive; typically five to ten sentences describing the context and the decision are adequate. The resolution should be saved in the corporate records, in case the decision is later challenged.

The Church

The Catholic Church and its organizations do not receive special protection from the penalties of violations of the laws related to private inurement and private benefit. With the increased clamor for accountability and transparency, the Catholic Church's leadership, parishes, organizations, and ministries should be aware of the serious implications of private inurement and private benefit violations, as well as the related concept of excess benefit transactions and the severity of the excise tax on excess benefits transactions, which will be set forth in a subsequent whitepaper in this series. In addition, the organization's tax-exempt status potentially can be revoked. This would cause the organization to lose the benefits associated with tax-exempt status, such as the exemption from property taxes.