150. Private Benefit and Inurement

Baylor University has been granted federal income tax exemption from the IRS by being classified as a 501(c)(3) organization. To qualify for and maintain this federal exemption status, Baylor must be both organized and operated exclusively for one or more tax exempt purposes. To satisfy the IRS's organizational test, an organization's documents of creation must limit its activities to exempt purposes and structure the organization properly. Baylor University's Articles of Incorporation and Bylaws satisfy these requirements. To satisfy the operational test, an organization must meet the following three prongs:

> (1) the organization must engage primarily in activities that accomplish one or more of the exempt purposes listed in IRC §501(c)(3), including religious, charitable, scientific, literary, and educational purposes;
>
> (2) the organization's net earnings cannot inure in whole or in part to the benefit of private shareholders or individuals; and
>
> (3) the organization cannot be an action organization, meaning the organization cannot devote a substantial part of its activities to attempting to influence legislation or participate in political campaigns.

Below are further details regarding how the University can meet the first two tests. The final test is met through the day-to-day operations of the university.

Private Benefit

To satisfy the first prong of the operational test, Baylor University must engage primarily in activities that accomplish one or more of its exempt purposes. An organization is not operated exclusively for one or more exempt purposes if it operates for the benefit of private parties.

Private benefit occurs in a transaction or exchange between a tax-exempt organization and one of its “insiders” that furthers private interest (typically the interests of the “insider”), rather than the public interest. If private benefit is found to exist in a tax-exempt organization, it can be the basis for revocation of the tax-exempt status of that organization. Any private benefit from an activity must be “incidental” in both a “qualitative” and a “quantitative” sense to the overall public benefit of the activity.

A benefit is qualitatively incidental when the benefit to the individual is only a by-product of providing the benefit to the public. To be quantitatively incidental, the private benefit in question must be insubstantial in amount when compared to the public benefit of the activity.

IRC Section 501(c)(3); IRS Treasury Regulation 1.501(c)(3)-1(c)(2)

Inurement

The second prong of the operational test is that the organization's net earnings cannot inure in whole or in part to the benefit of private individuals. This second prong differs from the first in that private inurement is a benefit provided only to “insiders”, individuals who have the opportunity to direct the organization's resources to themselves, to family members, or to entities in which they have an interest. The IRS has stated there is no permissible level of private inurement, no matter how small.

Inurement occurs when a transaction or exchange occurs whereby an individual with a personal interest in the exempt organization activities acquires economic gain through the use of funds or assets of that exempt organization. It should be noted that there is nothing wrong with “insiders” transacting with the exempt organization, as long as reasonable compensation at fair market values is exchanged.

In IRS Revenue Ruling 69-383 the IRS developed a three-part test for determining whether a compensation arrangement results in prohibited inurement.

- Is the compensation arrangement consistent with exempt purposes? The compensation arrangement must be designed to further the organization’s exempt purposes, rather than to advance the private interests of the individual being compensated.
- Is the compensation arrangement the result of arm’s length bargaining? Compensation arrangements must result either from arm’s-length negotiations between the employer and employee or be pursuant to a plan or arrangement covering a broad class of non-controlling or non-management employees. As to executives and other controlling members of an exempt organization, the organization must enforce policies and procedures designed to prevent conflict of interest and ensure independent approval.
- Does the compensation arrangement result in reasonable compensation? Whether compensation is reasonable is a question of fact to be determined in light of all the circumstances. The payments must be intended as compensation, rather than a distribution of profits. Also, the compensation must be equivalent to the value of services performed. The compensation should relate to the requirements of the job, the amount of time and effort expended in the job, and the individual’s qualifications.

The IRS indicates that there is no “de minimis” amount of permissible inurement. Findings of private inurement can also be grounds for revocation of the tax-exempt status of an organization and, as opposed to private benefit, can be the basis for assessing employment tax liabilities against the organization for unreported income.

When a transaction is determined to generate private inurement, if the individual involved is a disqualified person, the transaction is also deemed an excess benefit transaction. If an excess benefit transaction is found, the IRS will impose penalty excise taxes (intermediate sanctions) on the individual, and the organization may lose its tax-exempt status along with the imposition of the penalty taxes.

Disqualified Persons

A disqualified person is any person in a position to exert substantial influence over the organization's affairs at any time in the five years before the transaction occurred. Family members and any entities controlled by the disqualified person are considered disqualified persons. Control is defined as owning more than 35% voting power of the organization. The following powers are considered by the IRS to be the ability to exert substantial influence: (1) a voting member of the organization's governing body; (2) a person with ultimate responsibility for implementing the governing body's decisions or for supervising the management, administration or operation of the organization; (3) a person with ultimate responsibility for managing the organization's finances.

Excess Benefit Transaction

An excess benefit transaction is defined as a transaction in which an economic benefit is provided by an organization, directly or indirectly, to or for the use of a disqualified person, and the value of the benefit provided by the organization exceeds the value of the consideration received by the organization in return.

Areas of Risk

Previous IRS activities provide some insight into potential areas of risk for private benefit or private inurement. IRS auditors review contractual relationships and compensation arrangements to determine whether there is a clear community benefit (exempt purpose), or whether private benefit and/or inurement exists. Specific target groups of employee's subject to IRS scrutiny include:

- athletic department officials;
- principal investigators on research projects where there is potential commercial viability of the results of the research;
- executive management, deans, directors, departments heads, etc.; and
- executive management of related organizations.

Some IRS auditors have reviewed for specific types of transactions that indicate the possible existence of private benefit or inurement. Targeted transactions include:

- those relating to athletic camps conducted on university/agency property;
- payment of below market rents for space or equipment, if provided by the institution to the insider;
- payment of below market compensation for use of support services, if provided by the institution to the insider;
- payment of above market rents for space or equipment, if provided by the insider to the institution;
- payment of above market compensation for use of support services, if provided by insider to the institution;
- minimum income guarantees and inadequately secured loans; and
- technology transfer transactions involving principal investigators.

The Controller's Office has primary responsibility for determination of private benefit or private inurement and should be consulted on any questionable or unclear payments.