D. INUREMENT

1. Introduction

This topic will explore the concept of inurement as it affects the scope of exemption from federal income tax. Although the inurement principle appears in a number of paragraphs of IRC 501(c), including (c)(3), (c)(6), (c)(7), (c)(9), (c)(11), (c)(13) and (c)(19), this analysis will focus on inurement and IRC 501(c)(3). A number of situations and activities which have been determined to constitute inurement will be examined and the methods used to identify them will be discussed. Particular attention will be given to inurement arising from excessive compensation, conversion of a for-profit organization to non-profit, and home health agencies. The analysis is intended to supplement rather than replace the inurement discussion in the Exempt Organizations Handbook, IRM 7751, paragraphs 381 and 382.

2. Background

IRC 501(c)(3) provides for the exemption from federal income tax of a number of different types of organizations all of which are subject to the general qualification that no part of their "net earnings" inure to the benefit of any "private shareholder or individual." This inurement reference has its origins in the Tariff Act of 1909, Ch. 6, sect. 38, 36 Stat. 112, which provided for an excise tax applicable to for-profit corporations, joint stock companies and associations. An amendment to the bill was introduced by Senator Augustus Octavius Bacon of Georgia which provided for an exemption from the excise tax for "any corporation or association organized and operated exclusively for religious, charitable or educational purposes, no part of the net income of which inures to the benefit of any private shareholder or individual." Except for a change of "net income" to "net earnings" in the Revenue Act of 1918, the inurement phrase has remained unchanged down to its present incorporation in IRC 501(c)(3).

The Code's reference to inurement is expanded in Reg. 1.501(c)(3)-1(d)(1)(ii) which provides that qualification under IRC 501(c)(3) is not available for organizations operated for the benefit of designated individuals or persons who created the organizations. Reg. 1.501(c)(3)-1(c)(2) echoes the Code's inurement language. A cross-reference to Reg. 1.501(a)(1)-1(c) which defines "private shareholder or individual" as those persons having a personal and private interest in the activities of an organization, emphasizes that the focus of the inurement proscription is on those who, by virtue of a special relationship with the organization in question, are able to influence the expenditure of its funds or the use of its assets. From the regulations arises the working definition of inurement as "insider benefit." The use of the term "insider" serves to distinguish inurement from the broader concept of private benefit which is not included in this discussion.

The use of the term "benefit" highlights the broad interpretation placed on the Code language of "net earnings." While appearing, at least nominally, to be limiting inurement to the diversion of a certain class of funds, the "net earnings" reference goes beyond a narrow accounting definition of net income to encompass almost any use, other than in an arm's length transaction or as reasonable compensation, made of an organization's assets by an insider. As will be noted in the discussion, however, the concept of inurement is not as stringent as that of self-dealing under IRC 4941.

3. Discussion

A. IDENTIFYING INUREMENT

The identification of inurement in either a determination or an examination situation is a function of the care with which case development is pursued. Many forms of inurement come to light only upon careful examination of documents such as contracts for supplies or services, loan agreements with nominally third parties, and sale/lease agreements. Before reviewing such documents, however, it is imperative that the particular organization's "insiders," generally officers and directors, be identified. When reviewing an organization's books and records as described in paragraph 153 of the Exempt Organizations Examination Guidelines Handbook (IRM 7(10)69), specialists should be alert to the appearance of insiders' names in a context indicating that the individuals are not acting as representatives of the exempt organization. Transactions with family members may first come to light through such a review of books and records.

Once it has been determined that an exempt organization has engaged in a transaction with an insider or an insider has used an organization's assets, the possibility of inurement must be considered. In making a determination on whether inurement is present, the specialist must ascertain whether the transaction at interest constitutes part of the individual's stated compensation package or whether it forms part of an arm's length transaction in which the interests of the exempt organization were fully protected. If neither category of exception describes the situation, it is likely that the situation constitutes inurement.

Various factual patterns which the Service has deemed inurement have been reviewed by the courts. Some situations, such as that described in Founding Church of Scientology v. U.S., 412 F.2d 1197 (Ct. Cl. 1969), involve classic across-the-board channeling of an organization's funds to those in control of the organization. In that case, a wide variety of devices were employed, including fees, commissions, excessive rental payments, loans and excessive salaries, to divert the organization's funds to its founder, L. Ron Hubbard, and his immediate family. The principle of inurement was neatly summarized when the Court stated, "what emerges from these facts is the inference that the Hubbard family was entitled to make ready personal use of the corporate earnings." See also John Marshall Law School v. U.S., 81-2 U.S.T.C. 9514 (Ct. Cl. 1981), in which the Court found that the Commissioner acted properly in revoking exemption under IRC 501(c)(3) on the grounds of inurement to the controlling officers and their families. The inurement included, but was not limited to, payments to the families as follows: automobile, education and travel expenses, insurance policies, basketball and hockey tickets, membership in a private eating establishment, membership in a health spa, interest-free loans, home repairs, personal household furnishings and appliances, and golfing equipment.

There is a third limited exception to the general inurement doctrine based on the situation in which an incidental amount of inurement occurs but is outweighed by the public benefit occurring at the same time. Rev. Rul. 74-146, 1974-1 C.B. 129, illustrates the exception in the case of a nonprofit organization of accredited educational institutions, whose membership includes a small number of proprietary schools. The organization is controlled by its members and engages in the preparation of accreditation standards, identification of schools and colleges meeting the standards, and the dissemination of accredited institution lists. Any private benefit that accrues to the new proprietary members because of the accreditation is considered to be incidental to the purpose of improving the quality of education.

B. SPECIAL SITUATIONS

1. Excessive Compensation

One enduring method of siphoning off an exempt organization's assets is the device of excessive compensation. As noted earlier in this discussion, one of the exceptions to inurement is "reasonable" compensation. A determination of reasonableness is a question of fact that must be resolved on a case-by-case basis. In addition to its applicability in exempt organizations questions through IRC 501(c)(3) and, in the case of private foundations, the self-dealing provisions of IRC 4941, the question of the reasonableness of compensation also arises under IRC 162 concerning the deductibility of business expenses. Accordingly, guidance in judging reasonableness in an exempt organization situation can be derived from the Service experience in administering IRC 162. This use of IRC 162 was adopted by the Court of Claims in a case involving the predecessors to IRC 501(c)(3) and IRC 162 in the 1939 Code (Enterprise Railway Equipment Company v. U.S., 161 F. Supp. 590 (Ct. Cl. 1958)).

The general rule in compensation questions under IRC 162 can be expressed as: reasonable compensation is that amount that would ordinarily be paid for like services by like organizations in like circumstances (Reg. 1.162-7(b,(3)). It is important to remember that this "like" rule is applied to total compensation, not just that portion of an individual's remuneration labeled salary, and includes contributions to pension plans, payments of personal expenses, and bonuses. In the context of IRC 501(c)(3), Rev. Rul. 73-126, 1973-1 C.B. 220, describes a situation in which it was determined that an exempt organization's payment of reasonable pensions to retired employees at the discretion of directors constitutes reasonable compensation and does not adversely affect the organization's exempt status. Thus, IRC 501(c)(3) utilizes the same expanded concept of compensation found in IRC 162.

In the context of IRC 162, factors taken into consideration in making a reasonableness determination include: the nature of duties, the individual's background and experience, the individual's knowledge of the business, the size of the business, the individual's contribution to profit making, the time devoted, the economic conditions in general, and locally, the character and amount of responsibility, the time of year compensation is determined, the relationship of a stockholder-officer's compensation to stockholding whether alleged compensation is, in reality, in whole or in part, payment for a business or assets acquired, and the amount paid by similar size businesses in the same area to equally qualified employees for similar services. With some changes to adapt the preceding factors to the nonprofit, nonstock nature of exempt organizations, the IRC 162 factors can be useful in judging the reasonableness of compensation arrangements under IRC 501(c)(3).

Compensation questions often arise in the context of medical care organizations that employ highly paid professionals to provide health care services. See the 1981 CPE Text, pages 20-25, concerning compensation questions in the context of faculty group practice organizations. One compensation method devised by these organizations to ensure an income level sufficient to retain the services of their professionals is the "fixed percentage of income" method described in Rev. Rul. 69-383, 1969-2 C.B. 113. In the revenue ruling, the exempt status of a hospital was not jeopardized where, after arm's length negotiations, it entered into an agreement with a hospital-based radiologist to compensate him on the basis of a fixed percentage of the departmental income. Income was defined as the department's gross billings adjusted by an allowance for bad debts. Critical elements of this contingent compensation arrangement are the individual's status as an employee (as opposed to managerial or control status) and the arm's length nature of the negotiations. Situations in which the professional staff retained control over their own compensation would not come within the scope of the revenue ruling. In addition to the factors described in the revenue ruling, in a number of cases the National Office has found other factors to be significant including: (1) the contingent payments serve a real and discernable business purpose of the exempt organization independent of any purpose to operate the organization for the direct or indirect benefit of the employee/professional (e.g., achieving maximum efficiency and economy by shifting away the principal risk of operating cost to the employee/professional so as to alleviate the organization's need to carry large insurance-type reserves); (2) the amount of compensation is not dependent principally upon incoming revenue of the exempt organization, but rather upon the accomplishment of charitable objectives of the organization (e.g., the success of the employer organization and the employee/professional in keeping actual expenses within the limits of projected expenses upon which the ultimate prices of charitable services are based); (3) a review of the actual operating results reveals no evidence of abuse or unwarranted benefits (e.g., prices and operating costs compare favorably with those of other, similar organizations); and (4) the presence of a ceiling or reasonable maximum so as to avoid the possibility of a windfall benefit to the employee/professional based upon factors bearing no direct relationship to the level of service provided. Different combinations of the preceding factors have been found by the National Office to preclude inurement in various factual situations. Not all the factors need be present in a particular case to achieve that result.

The "reasonableness" approach to contingent compensation can also be applied to situations in which an IRC 501(c)(3) organization has established a qualified profit-sharing plan under IRC 401(a). The current thinking in the

National Office is that such incentive compensation plans in which profits are a factor in the compensation formula generally will not result in inurement if the plan is adequately limited and safeguarded through the provisions of Subchapter D of Chapter 1 (deferred compensation, etc.) and Chapter 43 of the Code (qualified pension plans, etc.) as well as those of Title I of P.L. 93-406, the Employee Retirement Income Security Act (ERISA) of 1974. As indicated earlier, however, the excessive compensation determination is based on total employee benefits, not just salary.

The National Office has found that benefit to an exempt organization's employees, so long as it constitutes no more than reasonable compensation for services rendered, is not necessarily incompatible or inconsistent with the accomplishment of the exempt purpose of the employer. Exempt organizations can establish and operate incentive plans that devote a portion of receipts to reasonable compensation of productive employees so long as the benefits derived from the plans generally accrue not only to employees but also to charitable employers through, for instance, increased productivity and cost stability, thus aiding rather than detracting from the accomplishment of exempt purposes.

2. Conversion of For-Profit Organization to Non-profit

A number of instances in which inurement has been found have involved the conversion of a for-profit or proprietary organization to a non-profit method of operation. As described in Rev. Rul. 76-441, 1976-2 C.B. 147, the assumption by the non-profit organization of liabilities and assets of a for-profit entity can result in inurement when the value of the assets is exceeded by the amount of liabilities and both organizations are controlled by the same individual or individuals. See also, Hancock Academy of Savannah, Inc. v. Commissioner, 69 T.C. 488 (1977), in which the Court found that consideration given by a newly formed school in exchange for the goodwill of an older proprietary institution was excessive. Similarly, if assets are simply sold to the non-profit organization rather than transferred in exchange for the assumption of liabilities, inurement can occur if an excessive price is paid. In such situations, the valuation of the assets and liabilities is critical. The fair market value of some assets, such as publicly-traded stocks and bonds, is easily established. The value of assets such as real or personal property, however, generally must be estimated. At a minimum, estimates of fair market value from independent qualified appraisers are required. Essential in any appraisal report is a complete description of the property, including, in the case of real property, street address, legal description, lot and block number, and physical features. Intangible assets, such as goodwill, pose special valuation problems. See

Rev. Rul. 76-91, 1976-1 C.B. 149, in which the valuation of intangible assets through the capitalization of excess earnings formula did not result in the inurement of a hospital's net earnings.

3. Home Health Agencies (HHAs)

Home health agencies are defined in the Social Security Act (42 U.S.C. 1395x(o)) as organizations primarily engaged in providing skilled nursing services and other therapeutic services to patients in their homes. To be a qualified HHA under the Social Security Act, an organization must either be exempt under IRC 501 or be licensed pursuant to a State law. Rev. Rul. 72-209, 1972-1 C.B. 148, provides that qualified HHAs are exempt under IRC 501(c)(3).

In 1979, the General Accounting Office (GAO) issued a report on a general review of home health care agencies which discussed a number of abuse situations. The GAO is also studying the Service administration of the Internal Revenue Code sections applicable to HHAs. In addition, in May 1981 the Senate Permanent Subcommittee on Investigations held hearings on fraud and abuse in HHAs as it affects Medicare.

The GAO, in its 1979 Report to the Congress, Home Health Care Services -- Tighter Fiscal Controls Needed (HRD-79-17, May 15, 1979), highlights the following abuse situations that were found to exist in the home health care area:

(a) Inurement of Net Earnings

An HHA claimed costs relating to European trips for its president, treasurer, acting administrator, and their spouses. HHA officials claimed Medicare reimbursement for several other trips, including trips to Boston, New Orleans, and New York. The HHA also claimed expenses for local restaurant charges, flowers for various individuals, a fishing trip and "board conference," and membership in a local country club.

(b) Leasing Office Space

An HHA rented office space at excessive costs from a company owned by the HHA's C.P.A. firm, which organized the HHA. Also, the HHA rented more space than it needed. The administrator stated that she had no authority to seek other facilities without prior approval from the board of directors, which was controlled by the C.P.A. firm.

(c) Franchising

HHAs are sometimes created by for-profit organizations under agreements that resemble franchise agreements. One such agreement required the HHA to purchase manuals and business forms from the for-profit organization (licensor) and to pay a licensing fee. The licensor had the right to examine the HHA's books. Also, the HHA was prohibited from establishing another health agency within 50 miles should the agreement be terminated, was required to comply with minimum performance standards established by the licensor, and could not assign the contract to a new owner without the licensor's consent. The term of the contract was for 35 years. Under the contract, the licensor also supplied the agency with accounting, data processing, and other management services.

(d) Long-Term Contracts

Similar to the franchising arrangements described above, a for-profit organization will organize an HHA and enter into a long-term contract with the HHA to provide accounting, data processing, and other management services. Owners of the for-profit organization also serve on the board of the HHA at the time the contracts are entered into. The agreement may require the HHA to pay a percentage of its monthly gross billings or receipts to the for-profit organization.

(e) Use of HHA Facilities by a For-Profit Organization

In one case noted by GAO, a for-profit organization and the HHA that it had organized were located on the same floor of an office building and were billed separately for the space they leased. However, the for-profit organization was found to have used the HHA's office space to conduct its business. The for-profit organization also charged long distance telephone calls to the HHA.

The issue presented in each of these situations is whether the HHA's net earnings inure to the benefit of private shareholders or individuals, and whether the HHA is operated for the benefit of private interests. Common to all of the above situations is the fact that the HHAs involved are not governed by independent boards, i.e., boards that have no economic interests in the HHA. Particularly in those situations where an independent board is not present, the specialist should determine whether any abuse-type activities, such as the ones described above, exist. The arm's length and reasonableness tests described in the preceding discussion should be utilized to judge the HHA's operation. In addition, specialists should refer to IRM 7(10)69, Examination Guidelines, paragraph 336, concerning home health care organizations.

4. Conclusion

While the preceding discussion has focused on several examples of inurement, specialists should be aware that the issue is first and foremost a factual one and, accordingly, will vary with the facts of a particular case. The forms which inurement can take are limited only by the imagination of the insiders involved.