LAND TRUST ALLIANCE
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LAW UPDATE

Staying Within the Bounds of the Income Tax Code and Public Perception: Private Inurement and Private Benefit

Working or volunteering for a nonprofit, tax-exempt land trust carries a host of responsibilities. One is to maintain the tax-exempt status of the organization. As a board member, executive director, or staff member, you must be aware of pitfalls that could jeopardize this status.

This article defines and discusses private inurement and private benefit, both of which could place your organization's tax-exempt status at risk under section 501(c)(3) of the Internal Revenue Code. In the next edition of *Exchange* we will discuss two other potential problems — excess benefit and conflict of interest.

Private Inurement

I.R.C. §501(c)(3) instructs that a tax-exempt charitable organization must be organized and operated so that no part of its net earnings "inures to the benefit of any private shareholder or individual." The measure against private inurement ensures that a tax-exempt charitable organization serves a public interest, and not a private interest.

The private inurement doctrine forbids the flow of income or assets from a tax-exempt organization, such as a land trust, to individuals with some significant relationship to the organization, especially when that transaction is unrelated to the organization's tax-exempt purpose, as outlined in its application for tax exempt status under §501(c)(3).

The concept of the "insider" who benefits from a transaction for "nonexempt" purposes is intrinsic to private inurement. An "insider" can be an organization's founder, trustee, director, officer, key employee, members of the family of these individuals, and certain entities controlled by them — essentially any person with access to or influence over an organization's funds or assets.

The private inurement doctrine does not necessarily prohibit all transactions between a land trust and an insider, but it requires that such transactions be tested against a standard of reasonableness when compared with the transactions of similar organizations in similar circumstances. Because a finding of private inurement could ultimately result in the forfeiture of an organization's status as a 501(c)(3) organization, and therefore its status as a land trust, it is imperative to understand what sorts of transactions may qualify as private inurement.

If you could qualify as an "insider" at your land trust and you begin to feel yourself putting your own interests ahead of the organization's, take this as a warning that you are nearing the realm of private inurement.

For instance, if you are a realtor on a land trust board, do not use inside information — such as a potential conservation easement being placed on land next to a property on the market — to encourage potential buyers and thereby increase your business.

From another perspective, if you serve on a land trust board with a realtor as a member, keep in mind that the land trust's actions must not create an unreasonable benefit for your fellow board member. For example, the realtor should not be overcompensated for a land transaction in which the land trust and the realtor are both involved. Another example of private inurement might occur if your land trust rents a house on land it owns to a relative of a board or staff member at less than fair market value.

Private Benefit

Unlike private inurement, private benefit is not limited to circumstances where benefits accrue to an organization's "insiders." Instead, private benefit occurs when benefits go to "disinterested persons," or those unrelated to the organization's insider operations. As with private inurement, any benefit that is not a benefit for the public at large is subject to scrutiny, and a finding of private benefit jeopardizes a nonprofit's tax exempt status under I.R.C. §501(c)(3).

Although charitable organizations such as land trusts may provide benefits to private individuals, these benefits must be incidental. Incidental benefits are considered to be those benefits that are insubstantial when measured in the context of the overall public benefit conferred by the activity. Incidental benefits occur as part the nonprofit's public purpose and activity, which cannot be achieved without benefiting some private individuals. For example, the incidental benefits to an adjoining property owner that typically result from a conservation easement both fall within the land trust's mission and are insubstantial in the context of the overall benefit of protecting the property. Such incidental benefits to the adjoining property owner would not be considered a private benefit.

However, if your land trust begins to benefit an individual or a distinct group of individuals in ways that are more than incidental, you are heading towards private benefit. For instance, if you amend a conservation easement to provide more development rights in detriment to the conservation values of the property, you are arguably acting for the sole benefit of the landowner — a "disinterested individual" — without regard for the public interest, and to the detriment of the conservation purpose of your orga

nization. Or, if you hire a fund-raiser to increase your land trust's endowment, but "compensate" that fund-raiser with an overwhelming amount of the funds raised, you may be granting a private benefit to a disinterested individual and straying from the objective of your tax-exempt organization. (A federal court recently remanded for further findings a private benefit case where a fund-raiser who raised $28.8 million in donations from the public for a nonprofit, tax-exempt organization kept the majority of the funds and only gave $2.3 million to the nonprofit organization). When in doubt, be more cautious than less.

Knowing and respecting the boundaries of private inurement and private benefit when dealing in land trust transactions should help you to protect both your land trust's assets, and its tax-exempt status.

In the next issue of *Exchange*, we will discuss conflict of interest and the newly proposed regulations for "excess benefit" dealing with private inurement and private benefit.

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