

# When is Incentive Compensation - Impermissible Private Inurement?

**Hypothetical:** A nonprofit affordable housing developer pays its CEO a fixed salary PLUS, as incentive, it gives her a percentage of the net revenues generated from the sale of each house (or alternatively, a percentage of the gross charitable contributions that she is able to solicit for the organization..

**Question:** will such incentive compensation get the organization in trouble with the IRS?

**Discussion:** Section 501(c)(3) of the IRS Code requires that an organization be organized and operated exclusively for exempt purposes. Reg. 1.501(c)(3)-1(c) (1) provides that an organization will be regarded as operated exclusively for exempt purposes only if it engages primarily in activities that accomplish one or more of the exempt purposes specified in IRC 501(c)(3). But an organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Thus, an organization that operates primarily in a manner that results in conferring impermissible private benefit on one or more persons does not satisfy this requirement

Thus, any compensation arrangement between a 501(c)(3) organization and an employee or an independent contractor must not result in private inurement if that person is an insider, and must not confer impermissible private benefit whether or not that person is an insider. IRC 501(c)(4) also contains a prohibition against inurement of net earnings to the benefit of any private shareholder or individual.

Implicit in these two proscriptions is the requirement that the compensation actually paid must be reasonable.

## Factors in Determining Whether Improper Private Benefit or Inurement Exists

In analyzing incentive compensation arrangements between physician insiders and exempt hospitals the IRS has generally considered various factors to determine whether the arrangement violates the proscriptions against private inurement and impermissible private benefit.

**A. Independent Board of Directors and Conflicts of Interest Policy.**  
Was the compensation arrangement established by an independent board of directors or by an independent compensation committee?

**B. Reasonable Compensation** Does the compensation arrangement result in total compensation that is reasonable? The IRS will not rule on whether compensation to be paid to any particular employee is reasonable since this involves a factual matter that cannot be determined in advance.

**C. Arm's-Length Relationship** Is there an arm's-length relationship between the organization and the contractor, or does the contractor participate impermissibly in the management or control of the organization in a manner that affects the compensation arrangement?

**D. Ceiling** Does the compensation arrangement include a ceiling or reasonable maximum on the amount a physician may earn to protect against projection errors or substantial windfall benefits?

**E. Reduction in Charitable Programs** Does the compensation arrangement have the potential for reducing the charitable services or benefits that the organization would otherwise provide?

**F. Net Revenue Based** If the amount a contractor earns under the compensation arrangement depends on net revenues, does the arrangement accomplish the organization's charitable purposes, such as keeping actual expenses within budgeted amounts, where expenses determine the amounts the organization charges for charitable services?

**H. Joint Venture** Does the compensation arrangement transform the principal activity of the organization into a joint venture between it and a group of physicians?

**I. Distribution of Profits** Is the compensation arrangement merely a device to distribute all or a portion of the health care organization's profits to persons who are in control of the organization?

**J. Business Purpose** Does the compensation arrangement serve a real and discernible business purpose of the exempt organization, such as to achieve maximum efficiency and economy in operations that is independent of any purpose to operate the organization for the impermissible direct or indirect benefit of the contractors?

**K. Abuse or Unwarranted Benefits** Does the compensation arrangement result in no abuse or unwarranted benefits because, for example, prices and operating costs compare favorably with those of other similar organizations? Effective controls to guard against unnecessary utilization are also important.

**L. Services Personally Performed** Does the compensation arrangement reward the contractor based on services the physician actually performs, or based on performance in an area where the contractor performs no significant functions?