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Non-Profit Organizations: Avoiding, Correcting and Reporting Excess Benefit Transactions

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Excess Benefit Transactions Under Section 4958 And Revocation Of Tax-Exempt Status

by David A. Levitt

When charities are generous to the wrong people, they risk losing their tax-exempt status.

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THE INTERNAL REVENUE SERVICE has issued final income tax regulations clarifying the substantive requirements for tax exemption under section 501(c)(3) of the Internal Revenue Code (all section references herein are to the Code) and the imposition of section 4958 excise taxes on excess benefit transactions. In addition to excise taxes that may be imposed under section 4958, the Internal Revenue Service may also revoke the tax-exempt status of an organization in appropriate circumstances. This article reviews the final regulations, effective March 28, 2008, that provide the framework by which the IRS will determine whether one or more excess benefit transactions are sufficient grounds for revocation of a section 501(c)(3) charitable organization's tax-exempt status.

SECTION 4958: INTERMEDIATE SANCTIONS • Section 501(c)(3) sets forth the requirements for qualifying as a tax-exempt charitable organization. The statute specifically requires that "no part of the net earnings of [the organization] inure to the benefit of any private shareholder or individual...." This prohibition on private inurement is interpreted by the IRS to mean that a tax-exempt charitable organization may not improperly transfer its financial resources to any insider of the organization.

Before the addition of section 4958, the only penalty the IRS could impose upon discovering instances of private inurement was revocation of an organization's tax-exempt status. Revocation is a harsh outcome for any charity and may not be appropriate under the circumstances. In addition, when a charity's tax exemption is revoked, ultimately it is the charity and its beneficiaries that suffer, rather than the insiders who improperly benefited.

Section 4958 provides the IRS with a less draconian alternative to revocation of exempt status, the ability to impose intermediate sanctions on any "excess benefit transaction" between an applicable exempt organization and an insider of that organization. Applicable exempt organizations include section 501(c)(3) charitable organizations, other than private foundations (which are subject to their own self-dealing rules under section 4941), and section 501(c)(4) social welfare organizations (which are not addressed by the new regulations). Section 4958 penalizes those individuals who have improperly benefited from transactions with an applicable organization and, in certain cases, the officers or directors who have approved the transaction.

Excess Benefit Transaction

An "excess benefit transaction" provides an excessive economic benefit to an insider of the organization, defined under the Code as a "disqualified person." An excess benefit occurs when the value of the benefit provided by the organization exceeds the value of what the disqualified person provides the organization in return. Excess benefit transactions often involve compensation of disqualified persons, but also can involve the sale or other transfer of property between a charity and a disqualified person, loans between a charity and a disqualified person, or the use by a disqualified person of a charity's assets, including intellectual property.

Disqualified Persons

"Disqualified persons" are persons who are, or in the previous five years before the transaction in question have been, in a position to exercise substantial influence over the organization's affairs. The definition includes the organization's directors as well as certain officers and key employees. Disqualified persons also include such persons' family members (e.g., spouses, children, grandchildren, ancestors, brothers, and sisters) and an entity that is more than 35 percent controlled by disqualified persons. Other persons may also exercise substantial influence over the charity's activities based on the facts and circumstances. Such persons could include the founder of the charity, a substantial contributor to the charity, a person with managerial authority over the charity's operations, or a person with control over a significant portion of the charity's budget.

Penalty Taxes

Section 4958 creates a two-tier excise tax on excess benefit transactions. A disqualified person who benefits from an excess benefit transaction with an applicable tax-exempt organization is liable for a tax of 25 percent of the excess benefit. The "excess benefit" is the amount by which the value of the consideration provided to the disqualified person exceeds the economic benefit provided by the disqualified person to the organization in return. If the 25 percent tax is imposed on an excess benefit transaction and the disqualified person does not correct the excess benefit within a certain amount of time, a second tier tax of 200 percent of the excess benefit is imposed on the disqualified person. For example, if a section 501(c)(3) organization was found to have paid $150,000 to a disqualified person in a transaction for which $100,000 was fair market value, the disqualified person would have to pay a tax of 25 percent of $50,000, or $12,500 to the IRS. In addition, the disqualified person would have to return the excess benefit of $50,000 to the

organization, or be subject to the added 200 percent penalty tax ($100,000).

Organization managers who participate in an excess benefit transaction knowingly, willfully, and without reasonable cause, are liable for a tax of 10 percent of the excess benefit. The tax for which all participating organization managers are liable cannot exceed $20,000 for any one excess benefit transaction.

Revocation

Any transaction resulting in an excess benefit to a disqualified person is likely also to violate the prohibition on private inurement under section 501(c)(3). Regardless of whether a particular transaction is subject to tax under section 4958, the existing regulations confirm that substantive requirements for tax exemption under section 501(c)(3) still apply. The legislative history to section 4958 provides that "intermediate sanctions...may be imposed...in lieu of, or in addition to, revocation of an organization's tax-exempt status." H. Rep. No. 104-506, 104th Cong., 2d Sess., at 59 (1996). In the preamble to the 2001 temporary regulations interpreting section 4958, the Service stated that it would exercise its administrative discretion in enforcing the requirements of section 4958 and section 501(c)(3) in accordance with the legislative history and that it would publish guidance regarding the factors it would consider as it gained more experience in administering section 4958. 66 Fed. Reg. 2155. We now have that additional guidance.

EXCISE TAXES VS. REVOCATION: THE NEW REGULATIONS • In September 2005, the IRS released proposed regulations addressing whether revocation of charitable tax-exempt status is appropriate when section 4958 excise taxes also apply. The final regulations, which add a new paragraph (f) to Treas. Reg. §1.501(c)(3)-1, provide guidance on factors that the IRS will consider in determining whether a charitable tax-exempt organization that engages in one or more excess benefit transactions will continue to be exempt under section 501(c)(3). The final regulations apply with respect to excess benefit transactions occurring after March 28, 2008. 73 Fed. Reg. 16519.

In determining whether to continue to recognize the tax-exempt status of a charitable organization described in section 501(c)(3) that engages in one or more excess benefit transactions, the final regulations state that the IRS will consider all relevant facts and circumstances, including, but not limited to, the following:

- The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred;
- The size and scope of the excess benefit transaction or transactions (collectively, if more than one) in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes;
- Whether the organization has been involved in multiple excess benefit transactions with one or more persons (in the final regulations, this factor was revised to substitute the term "multiple" for the word "repeated." The Service clarifies in the preamble that "multiple" refers to both repeated instances of the same or substantially similar excess benefit transaction and the presence of more than one excess benefit transaction, regardless of whether the transactions are the same or substantially similar, and in both cases regardless of whether they involve the same or different persons);
- Whether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions; and
- Whether the excess benefit transaction has been corrected, or the organization has made good faith efforts to seek correction from the disqualified person(s) who benefited from the excess benefit transaction.

The IRS will consider all factors in combination with each other. Depending on the particular situation, the IRS may assign greater or lesser weight to some factors than to others. The new regulations also state that the factors listed above will weigh more heavily in favor of continuing to recognize exemption *where the organization discovers the excess benefit transaction or transactions and acts before the IRS discovers the excess benefit transaction or transactions.* Further, with respect to the last factor listed above, correction after the excess benefit transaction or transactions are discovered by the IRS, by itself, is never a sufficient basis for continuing to recognize exemption.

The regulations also provide six examples illustrating how these factors are to be applied. For instance, the first two examples set forth opposite ends of the spectrum for how an organization might respond to an excess benefit transaction involving a museum that purchased art solely from its trustees at prices exceeding fair market value. (In one case, the organization loses its exemption; in the other it does not.) The subsequent examples describe excess benefit transactions involving a chief executive officer diverting a charity's assets to pay personal expenses, a charity's sale of a building at below fair market value to a company wholly owned by the charity's chief executive officer, the charity's payment of its chief financial officer's personal expenses that is not recognized as part of compensation, and the payment by a charity of excess compensation to several top executives.

In addition to the regulations addressing the relationship between charitable status and intermediate sanctions, the IRS also added three new examples to the 501(c)(3) regulations illustrating the charitable exemption requirement that an organization must serve a public rather than a private interest. These new examples demonstrate that impermissible private benefit may involve non-economic benefits as well as economic benefits, and that impermissible private benefit may arise *even if* specific payments to private interests are not excessive and do not raise fair market value issues. The focus of this article is on the regulations interpreting the intersection between revocation under section 501(c)(3) and excess benefit taxes under section 4958; however, tax practitioners should also be aware of these three new examples illustrating the private benefit doctrine.

Applying The New Regulations: Questions And Comments

Below are some questions and comments posed to the IRS during the public comment period between the issuance of the September 2005 proposed regulations and the release of the final regulations in March 2008 and how the IRS has responded.

What does it mean for the size and scope of a transaction to be significant in relation to the size and scope of an exempt organization's activities? Whether a transaction is significant is largely assumed in the examples provided in the final regulations. For instance, one example (Example 3) provides that the organization diverted "significant portions" of its funds to pay for personal expenses of the Chief Executive Officer that "significantly reduced the funds available" to conduct educational programs. In the next example, constructing a building addition is called "a significant undertaking" in relation to the organization's activities. However, these descriptions provide no guidance as to what the IRS might consider significant. In the preamble to the final regulations (the "Preamble"), the IRS states that whether an activity or an amount is "significant" or "de minimis" under the new regulations depends on the facts and circumstances. Thus, there is no specific threshold that makes a transaction "significant." The IRS specifically ruled out creating a safe harbor for transactions that clearly would not jeopardize tax-exempt status, for instance by measuring the excess benefit as a percentage of

the organization's overall expenditures and setting a minimum threshold for considering revocation.

Can a single excess benefit transaction warrant revocation? Most examples in the regulations involve repeated excess benefit transactions. One comment to the proposed regulations requested guidance regarding when the IRS would consider a single excess benefit transaction sufficient to jeopardize an organization's tax-exempt status. The IRS did not provide further guidance on this point, stating instead that such a determination would depend on the facts and circumstances of each particular transaction. In one significant case litigated by the IRS in 2002 involving huge intermediate sanctions in connection with an asset transfer (the IRS initially calculated that the disqualified persons owed excise taxes totaling approximately $250 million), the Tax Court found that it was *not* appropriate under those circumstances to conclude that a single transaction also required revocation of tax-exempt status. See *Caracci v. Commissioner*, 118 T.C. 379 (2002). The U.S. Court of Appeals for the Fifth Circuit ultimately reversed the Tax Court's finding that an excess benefit transaction had occurred and removed the excise taxes as well. 456 F.3d 444 (5th Cir. 2006). Nevertheless, even if it may be rare, the IRS takes the position that one transaction could be enough to trigger revocation if the fact and circumstances warrant.

Whether and under what circumstances is removal of a disqualified person necessary to avoid revocation? The answer to this question could be very important to an organization which might face additional severance payments, or substantial contract law damages and litigation costs, for terminating an employee. Example 6, which was not included in the 2005 proposed regulations but was added to the final version, illustrates that removal of a disqualified person is *not* necessary in all cases to retain exemption. In this example, the board attempted to follow procedures described under section 4958 for establishing a "rebuttable presumption of reasonableness" in setting pay for its top executives; the IRS concluded that the board did not rely on appropriate comparability data and therefore failed to establish this presumption. The IRS furthermore found the compensation set by the board to be excessive. In response to this conclusion, the organization did not seek to void certain executives' pay under existing employment contracts retroactively and did not seek correction of the excess benefit amounts already paid, in order to avoid potential liability for damages under state contract law. The organization did, however, implement safeguards designed to prevent future excess benefit transactions from occurring and renegotiated compensation packages on a going-forward basis. Both of these factors favored continued exemption.

This last example more generally illustrates that in some situations an organization can retain its tax-exempt status even if it does not correct an excess benefit transaction. According to the preamble to the final regulations, this is the case "if other factors, in combination, warrant continued exemption." With respect to correction, the IRS also states in the Preamble that it will take into account the organization's good faith and will consider the reasons behind an organization's failure to seek correction.

How important is conducting reasonable due diligence and implementing appropriate safeguards? Evidence that an organization's board of directors conducted appropriate due diligence or followed certain safeguards in connection with an excess benefit transaction is a factor that weighs in favor of continued exemption. According to the Preamble, "[t]he IRS and the Treasury Department agree that the organization's reliance on objectively reasonable internal controls and procedures, such as the procedures for establishing a rebuttable presumption of reasonableness, in approving a transaction that is later determined to be an excess benefit transaction, should be treated as a factor weighing in favor of continuing to recognize exemption." The

IRS will treat implementation of safeguards that are "reasonably calculated to prevent excess benefit transactions" as a circumstance favoring continued exemption, even if the safeguards were not implemented in direct response to the excess benefit transaction at issue but rather as a general matter of corporate governance or fiscal management. Furthermore, according to the preamble, "an organization may be treated as having implemented [reasonable] safeguards...even though the organization is contesting the existence of the excess benefit transaction(s) at issue."

What about other good governance practices? The IRS refused to adopt a comment to the proposed regulations that described specific actions boards of tax-exempt organizations should be required to take in order to improve governance and to prevent excess benefit transactions. The Preamble states that the purpose of the regulations is "to set forth an analytical framework for determining whether to revoke tax-exempt status if an organization engages in one or more excess benefit transactions," not to dictate specific governance procedures.

Nevertheless, we now know from the new Form 990 return, effective for fiscal years beginning in 2008, that the IRS has put a premium on good governance. The instructions to Part VI of the new Form 990 state that the IRS considers good governance policies and procedures "generally to improve tax compliance" and asserts that the absence of appropriate policies and procedures may lead to opportunities for excess benefit transactions and private inurement. Therefore, although not addressed in the final regulations, it is worth understanding and following the various governance policies and disclosure practices described in Part VI to the new Form 990 (the subject of another article). Even if not legally required, one would expect that adherence to these practices would favor continued exemption.

Determination of fair market value. The examples in the proposed regulations assume that compensation clearly exceeds fair market value. However, valuation is often the most difficult question in determining whether an excess benefit has occurred. One comment to the proposed regulations suggested that a good faith attempt by an organization's board of directors to determine fair market value be treated as a factor precluding revocation, even if the IRS disagrees with the board's fair market value analysis.

The fourth factor in the final regulations takes into account whether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions. The procedure by which an organization attempts to determine fair market value, including through adopting the rebuttable presumption of reasonableness procedures, will be important if the organization and the IRS ultimately disagree on the actual fair market value. The importance of taking steps to avoid an excess benefit transaction, such as by attempting to determine the fair market value of the benefits involved, even when such steps have failed in the view of the IRS, will depend on the specific facts and circumstances.

Excess benefit transactions that are addressed post-audit. The regulations make clear that "correction after the excess benefit transaction or transactions are discovered by the Commissioner, by itself, is never a sufficient basis for continuing to recognize exemption." Treas. Reg. 1.501(c)(3)-1(f)(2)(iii). Nevertheless, in many cases, an organization may not recognize or agree that an excess benefit transaction has occurred. After a determination by the IRS, the organization may be prepared to correct the transaction and adopt safeguards to prevent future abuse. What additional factors, in addition to correction post-audit, would be sufficient to avoid revocation of exemption? The last example given in the new regulation illustrates a case where factors other than correction did support continued exemption. For instance, the organization added new members to the compensation committee with appropriate

expertise and amended its written procedures to ensure the use of appropriate comparability data. According to the Preamble, the IRS and the Treasury Department may consider publishing future guidance on the application of factors other than post-audit correction "based on other specific fact patterns that the IRS encounters in the course of tax administration."

CONCLUSION • The new regulations provide clear guidance as to how the IRS will analyze excess benefit transactions when determining whether to impose excise taxes exclusively or also to revoke charitable tax-exempt status. In an audit of a charity involving an excess benefit transaction, practitioners will want to review these factors to develop the strongest possible explanation as to why tax-exempt status should not be revoked in that case. Furthermore, before an examination ever occurs, practitioners can apply these factors when advising clients on how to respond to a transaction that might have produced an excess benefit under section 4958. For instance, the regulations emphasize the value of reacting to an excess benefit transaction *before* the IRS gets involved. Furthermore, the final regulations also place value on implementing certain safeguards and procedures going forward, even if they were not applied to the transaction in

PRACTICE CHECKLIST FOR
Excess Benefit Transactions Under Section 4958 And Revocation Of Tax Exempt Status

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