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Private Benefit Rules – Part III: Excess Benefit Transaction Rules

By Emily Chan (http://www.nonprofitlawblog.com/author/emily-chan/) on October 25, 2012

(http://www.nonprofitlawblog.com/assets/6a00d834558ca469e2017c32ca5be5970b-pi)The final private benefit rule discussed in this series is the excess benefit transaction rules, codified in section 4958 of the Internal Revenue Code ("IRC"), which are a similar but distinct set of rules from the private inurement doctrine discussed in Part II (http://www.nonprofitlawblog.com/home/2012/10/private-benefit-rules-part-ii-private-inurement-doctrine.html). Similar to the private inurement

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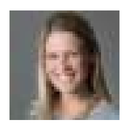

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doctrine, the excess benefit transactions rules are concerned with a certain subset of individuals who stand in a particular relationship with the organization. However, the excess benefit transaction rules have nuanced differences in applicability, penalties, and available protections.

Applicability of the Excess Benefit Transaction Rules

The excess benefit transaction rules apply to any entity that has status as a 501(c)(3) public charity or 501(c)(4) organization (i.e., social welfare organizations) at any time during a five-year look back period from the date the excess benefit transaction occurred:

- An excess benefit transaction is defined as any transaction in which an economic benefit is provided by the organization directly or indirectly to or for the use of any *disqualified person*, and the value of the economic benefit provided exceeds the value of consideration (including the performance of services) received for providing the benefit. (Treas. Reg. 53-4958-4(a)(1)).
- A disqualified person is a person in a position to exercise *substantial influence* over the affairs of the organization at any time during the five-year look back period from the date of the excess benefit transaction. (Treas. Reg. 53.4958-3(a)(1)).

The question of disqualification is factual inquiry that looks at actual powers and responsibilities as opposed to titles. Therefore, voting members of a governing body (e.g., directors) and those with the ultimate responsibility for implementing decisions of the governing body (e.g., President) or managing the finances of the organization (e.g., Chief Financial Officer) during the five year look back period would likely be considered disqualified irrespective of their titles in the organization and whether such influence was actually exercised. (See Treas. Reg. 53.4958-3(c)). Additionally some parties are automatically disqualified persons such as the family members of a disqualified person or an entity in which a disqualified person owns at least 35% control.

Additional facts and circumstances that tend to show substantial influence include (see Treas. Reg. 53.4959-3(e)(2)):

- The person founded the organization;
- The person's compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization that the person controls;
- The person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees; or
- The person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole.

Examples of Excess Benefit Transactions

Often the same situations that would trigger a private inurement issue also trigger a potential excess benefit transaction violation. Common situations include:

- *Loans to and from the Organization*. Federal tax law does not prohibit a disqualified person from making loans to the public charity or social welfare organization and vice versa. However, such loans have the potential for abuse and are a common problem area with regard to excess benefit transactions. The IRS is commonly concerned about the legitimacy of the loan and terms of repayment. Circumstances that help to show an excess benefit transaction has not occurred include:
  - The organization makes a bona fide loan to a disqualified person with an interest rate at or above market value;
  - The disqualified person makes a loan to the organization with an interest rate below market value; and/or
  - The recipient's intent to repay the amounts and transferor's expectation of repayment and intent to enforce payment are supported by evidence.
- *Compensation for Past Services*. Many nonprofit executives are paid below what a board might otherwise approve or desire to provide due to economic factors. Sometimes, a board will attempt to acknowledge the value of such services despite current limiting circumstances through arrangements such as an agreement at the outset to pay a higher amount at a later date for services to be rendered or an agreement at a later date to pay an additional amount in recognition of past services already rendered. The IRS will generally treat the deferred compensation as having been earned in equal amounts in each year unless there is sufficient

evidence to show an alternative payment schedule. The common concern here is whether the total compensation, in consideration of the services rendered over such time period, is reasonable. Circumstances that help to show an excess benefit transaction has not occurred include:
  - The total compensation the person received was less than the value of the services the person performed for the organization during the prior years;
  - The board followed the Rebuttable Presumption of Reasonableness for each year in question (see below); and/or
  - The board evaluated and concurrently documented its consideration of the annual aggregate compensation including the deferred compensation in comparison to the fair market value of such services for each year in question.

Penalties for Excess Benefit Transactions

If an excess benefit transaction has occurred, the IRS can levy taxes, commonly referred to as intermediate sanctions, on both the disqualified person who received the excess benefit and the organizational manager(s) who knowingly approved the excess benefit transaction. Pursuant to IRC section 4958, the IRS is authorized to impose the following penalties:

- 25% excise tax of the excess benefit on the disqualified person who received the excess benefit; and an additional 200% excise tax of the excess benefit if the violation is not corrected within the taxable period.
- 10% excise tax of the excess benefit on the organizational manager who knowingly participated in the transaction (maximum of up to $10,000).

Historically, the intermediate sanctions have been used as an alternative penalty to revocation under the private inurement doctrine because the penalty of revocation is so severe. However, the IRS can impose both the intermediate sanctions under the excess benefit transaction rules and revoke exempt-status under the private inurement doctrine for the same unlawful transaction.

Protections Against Excess Benefit Transactions

Compensation is probably the most problem-ridden area for exempt organizations with respect to excess benefit transactions. Luckily, the regulations provide for a process to create a presumption that payments under a compensation arrangement are reasonable (i.e., the Rebuttable Presumption of Reasonableness). Generally, if the IRS penalizes a disqualified person under the excess benefit transaction rules, such individual bears the burden to prove that the compensation arrangement was reasonable. However, if an organization follows the Rebuttable Presumption of Reasonableness procedures, the burden of proof shifts to the IRS to show the compensation arrangement was excessive. Therefore, while this presumption is rebuttable by the IRS, in practice, this creates an obstacle that the IRS is not likely to deal with unless a clear or egregious violation has occurred.

The Rebuttable Presumption of Reasonable consists of three steps:

1. The compensation arrangement or the terms of the property transfer are approved in advance by an authorized body of the organization composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement or property transfer (Treas. Reg. 53.4958-6(a)(1));
2. The authorized body obtained and relied upon appropriate data as to the comparability data prior to making its determination (Treas. Reg. 53.4958-6(a)(2)); and
3. The authorized body adequately documented the basis for its determination concurrently with making that determination (Treas. Reg. 53.4958-6(a)(3)).

Although the Rebuttal Presumption of Reasonable is prescribed with respect to compensation arrangements, it generally lays out a process that organizations are encouraged to follow in approving any transaction with a disqualified person or other individual with a possible conflict of interest.

Certain filing organizations should also remember that the annual information return with the IRS (i.e., Form 990 and Form 990-EZ), which is a publicly available document and signed under penalty of perjury, requires organizations to disclose whether an excess benefit transaction has occurred or the organization became aware that an excess benefit transaction has occurred in a prior year (see e.g., Form 990, Part VI, Question 89b). Organizations are well advised to understand the consequences of this rule both in terms of intermediate sanctions and the loss of good will and

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public trust that results from organizations that allow such violations to occur under their leaders' oversight.

For more information on excess benefit transactions, please see the following Internal Revenue Service Exempt Organizations Unit internal documents:

- AN INTRODUCTION TO I.R.C. 4958 (INTERMEDIATE SANCTIONS) (2002) (http://www.irs.gov/pub/irs-tege/eotopich02.pdf)
- Intermediate Sanctions (IRC 4958) Update (2003) (http://www.irs.gov/pub/irs-tege/eotopice03.pdf)

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