

Responding to an Excess Benefit Transaction

Part IV of a four-part overview of private inurement, private benefit, and excess benefit transactions

By Bonnie M. Wyllie, Lukinovich APLC

The first whitepaper in this series described the basics of private benefit and private inurement issues for tax-exempt organizations. The second whitepaper explained excess benefit transactions (a specific type of private benefit issue) and their consequences. The third whitepaper described best practices for avoiding excess benefit transactions.

This fourth and final whitepaper in the series outlines both what an organization's leaders should do if they believe an excess benefit transaction occurred and what to expect in the resolution and reporting process.

Executive Summary

- Leaders of exempt organizations should act promptly to correct potential excess benefit transactions.
- Seeking experienced counsel is key to determining (1) if an excess benefit transaction occurred; and (2) if so, how to best respond.
- Most excess benefit transactions are resolved through reporting and correction, which involves repayment to the organization of the excess benefit and payment to the IRS of the applicable penalties.
- If a tax-exempt organization engages in an excess benefit transaction, it is required to disclose it on its annual information return (Form 990 or 990-EZ) and on Form 4720.
- The IRS imposes three types of penalties on excess benefit transactions: (1) the excise tax; (2) a late correction penalty; and (3) a mindset-based penalty designed to punish repeat and willful offenders.
- Organizations can request that the IRS waive some or all the penalties, based on the parties' reasonable basis for entering the transaction and the parties' prompt correction of the violation.

Introduction

If an exempt organization's leaders believe that an excess benefit transaction may have occurred, the leaders must act to avoid incurring additional penalties and further jeopardizing the exempt organization's exempt status.

Specifically, organization leaders should promptly seek counsel from an attorney or accountant with experience working in this area. Excess benefit transaction reporting is very technical, so

seeking help from a professional who is not only familiar with tax law generally but also with this specific process is critical.

There is no “one-size-fits-all” response to a situation in which an excess benefit transaction may have occurred. The appropriate response strategy depends on factors such as when the transaction occurred, who was involved in the transaction, and whether the organization or its leaders have a history of excess benefit transactions.

This whitepaper will outline what an organization can expect when working with a professional in the aftermath of a potential excess benefit transaction, with a specific focus on what information will be necessary and what possible outcomes may be.

Analyzing whether an Excess Benefit Transaction Occurred

The first question to be addressed in the aftermath of a potential excess benefit transaction is whether a violation actually occurred. Careful analysis by an experienced professional is important. An improper report of an excess benefit transaction can needlessly damage an organization and impose fines on its leaders.

The key question in determining whether an excess benefit occurred is whether the benefit given to the disqualified person exceeded the fair market value of the services or property received by the organization. A professional will rely on any quotes the organization received for the services or property from other vendors, generally available market information, and perhaps a third-party assessment.

If the professional concludes that an excess benefit transaction did not occur, the organization should request a written opinion from the professional, describing his or her research and reasons for his or her conclusion. The written opinion should be kept with the corporate records in case the transaction is questioned in the future.

Responding to an Excess Benefit Transaction

If a professional concludes that an excess benefit transaction occurred, the next step involves both correcting the excess benefit transaction and reporting the excess benefit transaction.

Correcting the Excess Benefit Transaction

Prior to reporting the excess benefit transaction, the disqualified person or persons who benefitted from the transaction should correct the transaction by repaying the organization for the amount the person received above the fair market value of what he or she provided to

the organization.¹ In addition to repaying the excess benefit, the disqualified person should also pay interest based on the amount of time which passed between his or her receipt of the benefit and his or her repayment to the organization. The amount of interest to be charged is determined by multiplying the excess benefit by an interest rate, compounded annually, for the period from the date the excess benefit transaction occurred to the date of correction. The interest rate used must equal or exceed the applicable Federal rate (AFR) for the month in which the transaction occurred. The period of time from the occurrence of the excess benefit transaction to the correction determines whether the AFR used is the Federal short-term rate, the Federal mid-term rate, or the Federal long-term rate.²

Reporting the Excess Benefit Transaction

The IRS requires the parties involved in an excess benefit transaction to self-report. For the exempt organization, excess benefit transactions are reported in two places: (1) on the IRS Form 4720; and (2) on Schedule L of the IRS Form 990. The IRS Form 4720 requires information about the individuals involved in the transaction, including their names, addresses, and social security numbers.³ The IRS Form 4720 is paper filed and is not open for public inspection, so this sensitive personal information is kept private. The form also requires details regarding the transaction, including the pro rata portion of the excess benefit received and excise taxes owed by each party involved.

The disqualified person who benefitted from the excess benefit transaction can either sign the organization's IRS Form 4720 or choose to report the transaction on his or her own IRS Form 4720. In either case, the disqualified person should include the payment of the penalty with the form reporting the transaction.⁴

If an organization manager is also involved in the transaction, he or she may also report his or her participation either on the organization's IRS Form 4720 or on his or her IRS Form 4720. Again, the organization manager's penalty payment should be included with the form reporting the transaction.⁵

IRS Form 4720 is required to be filed with the IRS by the 15th day of the 5th month after the close of the tax year. If the tax-exempt organization files Form 990, the Form 4720 is due on

¹ I.R.C. § 4958(f)(6).

² Treas. Reg. § 53.4958-7(c)

³ Treas. Reg. § 53.6011-1(b), I.R.C. § 6033(b)(11)(A), I.R.M. 7.27.30.12 (11-17-2009), Instructions Form 4720.

⁴ I.R.C. § 4958(a)(1), I.R.C. § 6011(a), Treas. Reg. § 53.6011-1(b), I.R.M. 7.27.30.12 (11-17-2009), Instructions Form 4720

⁵ I.R.C. § 4958(a)(1), I.R.C. § 6011(a), Treas. Reg. § 53.6011-1(b), I.R.M. 7.27.30.12 (11-17-2009), Instructions Form 4720

the same filing date. Form 4720 for the disqualified persons and organization managers would be due on May 15th of the year following the occurrence of the EBT.⁶

Organizations Which Do Not Ordinarily File Form 990

Professional help is particularly important here for organizations which do not ordinarily file annual reports to the Internal Revenue Service. For example, churches and religious orders typically do not file the IRS Form 990 Annual Information Return. However, if this form is not filed, the IRS can assess penalties for the violation, including interest, at any time after the excess benefit transaction, even if years have passed.⁷ One noteworthy point, IRC Section 6033 does not prevent these Catholic organizations from voluntarily filing Form 990 or 990-EZ and reporting the transaction to start the statute of limitations, which will limit the time period the IRS can penalize those involved. If an organization correctly files an accurate and complete IRS Form 990, the IRS generally has a maximum of six years to impose additional penalties.⁸

Understanding Penalties

As described above, the disqualified person who benefits from an excess benefit transaction must repay the organization with interest. In addition to this repayment, the disqualified person also must pay a *25% penalty* on the value of the excess benefit to the IRS.

If an organization manager was involved with the transaction, the organization manager may be required also to pay a *10% penalty* (capped at \$20,000 for a single transaction) to the IRS, though an organization manager who had reasonable cause to participate in the transaction and did not know that the transaction was a potential violation of federal tax law will not be subject to a penalty.⁹ A professional can assist in determining whether, an organization manager will be subject to the penalty for participation in the transaction.

In addition to these basic penalties, if the transaction is not promptly corrected, the IRS can impose an additional penalty which doubles the amount of the excise tax imposed on the disqualified person.¹⁰ Generally speaking, the IRS considers a correction timely if it occurs within taxable period, in other words, on or before the earlier of the date of the notice of deficiency or the date of assessment of the excise tax.¹¹ For an organization which self-reports an excess benefit transaction, these IRS notices of deficiency would only be issued if the IRS

⁶ Treas. Reg. § 53.6071-1(f)(1)

⁷ IRM 7.27.30.11 (11-17-2009).

⁸ I.R.C. § 6501(e)(3).

⁹ I.R.C. § 4958(a)(1), I.R.C. § 6011(a), Treas. Reg. § 53.6011-1(b), I.R.M. 7.27.30.12 (11-17-2009), Instructions Form 4720.

¹⁰ Treas. Reg. § 53.4958-1(a).

¹¹ I.R.C. § 4963(e)(1).

concludes that the transaction was not corrected or that the organization's report undervalued the excess benefit.

Finally, a third layer of penalties can be imposed based on the disqualified persons' and participating organization managers' mindsets. Specifically, if the transaction took place without reasonable cause, the IRS also imposes a severe penalty on individuals who entered the excess benefit transactions either willfully or who already participated in excess benefit transactions in the past. The additional penalty doubles the amount of the excise tax imposed. For example, if the excise tax imposed was 25% of the value of the excess benefit, the additional penalty would be 25% of the excess benefit, which would total 50% of the excess benefit. Again, a professional can assist in determining whether this additional penalty applies.

Requesting Abatement

The IRS has identified certain situations in which the IRS will waive some or all the percentage penalties for an excess benefit transaction. To receive these waivers, an organization must request the waivers from the IRS, either on the IRS Form 4720 or on the IRS Form 843.

If an organization establishes that (a) the excess benefit transaction occurred due to reasonable cause, and (b) the transaction was promptly corrected, the IRS will waive all penalties.¹² Determining whether the transaction took place for "reasonable cause" is based on the facts and circumstances of the transaction. In general, if an organization manager does not know a transaction is an excess benefit transaction and he or she is exercising ordinary care and prudence in the transaction,¹³ the transaction may be deemed to have occurred for reasonable cause.

If a disqualified person promptly corrects an excess benefit transaction by repaying the organization, the 200% late penalty will be waived, even if the disqualified person or organization manager did not have reasonable cause for allowing the excess benefit transaction.¹⁴

Conclusion

Following the best practices outlined in the previous whitepapers in this series can help prevent organization's from facing situations in which these calculations and reports are necessary. However, if an organization believes an excess benefit transaction occurred, the leadership should quickly seek guidance from an experienced accountant or attorney. While it may be tempting to ignore past excess benefit transactions, doing so can result in considerable personal penalties on the parties involved and significant harm to the organization, both as a

¹² I.R.C. § 4962(a)(2).

¹³ Treas. Reg. § 53.4958-1(d)(6)

¹⁴ I.R.C. § 4961(a).

result of distracting the organization's leaders from executing on the mission and harming the organization's reputation. With guidance from experienced advisors, an organization can seek to resolve any previous mistakes and avoid future mistakes so as to move forward confidently.

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