Excess Benefit Transactions: The Incentive for Compliance

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

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The first whitepaper in this series described the basics of private benefit and private inurement issues for tax-exempt organizations. This second whitepaper explains a specific type of private inurement issue, the excess benefit transaction (EBT). This whitepaper also describes how to avoid an EBT and what the consequences are if an EBT takes place.

Executive Summary

- Penalties
    - IRC § 4958 imposes an excise tax of 25% on disqualified persons and imposes an additional excise tax of 200% if the excess benefit is not timely corrected.
    - IRC § 4958 imposes an excise tax of 10% of the amount involved with a cap at $20,000 on the organization managers that approved the transaction.
    - IRC § 6684 imposes a penalty equal to the IRC § 4958 excise tax imposed on any disqualified person or organization manager, if they have either previously been liable for a tax under IRC § 4958 or their act or failure to act is both willful and flagrant.

- An excess benefit is the amount the tax-exempt organization pays in excess of the fair market value of goods or services provided by a disqualified person. If the organization is selling an asset to a disqualified person for less than its fair market value, the excess benefit is the difference between the fair market value of the asset and its sales price.
- There are three categories of disqualified persons: (1) an individual in a position to exercise substantial influence over a tax-exempt organization, (2) family members of the individual in a position to exercise substantial influence, or (3) any business entity in which the individual in a position to exercise substantial influence, and/or his or her family members, own at least a 35% interest in the business entity.
- An organization manager is an officer, director, or trustee of the organization.
- An organization can take protective measures to prevent or minimize the effect of excess benefit transactions. These precautions include reliance on professional advice, exercising ordinary business care and prudence, meeting the rebuttable presumption of reasonableness, correcting the excess benefit, and requesting an abatement of tax.

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Introduction: How and Why Excess Benefit Transactions Matter to Tax-Exempt Organizations

Leaders of tax-exempt organizations need to protect themselves and the organizations they serve from improperly benefitting private individuals. Understanding when improper private benefit occurs is a first step. Understanding how to address or prevent an impermissible private benefit is equally important.

This whitepaper introduces the IRS regulations related to a specific private inurement issue called "excess benefit transactions" ("EBTs") and describes the steps an exempt organization and its leaders can take to address and prevent these improper transactions. The EBT regulations include incentives for compliance and authorize considerable personal penalties on persons who arrange or participate in transactions in which private persons who are outside any charitable class intended to be benefitted by the organization receive more from a tax-exempt organization than they give.

Defining the Terms

Excess Benefit Transaction

In an excess benefit transaction, an insider, called a disqualified person, "gets more than he pays for" from an exempt organization.[2] The "excess benefit" is the amount the tax-exempt organization pays in excess of the fair market value of the goods or services received from a disqualified person.

The following are some examples of situations where EBTs might occur.

- Sale of an asset by the tax-exempt organization for less than its fair market value;
- Excessive compensation arrangements, including compensation calculated as a percentage of the tax-exempt organization's revenues, without a cap placed on the actual compensation amount;
- Excessive payments for goods, services, or property;
- Rent paid to a tax-exempt organization that is less that the fair market rent for the property;
- Loan to a tax-exempt organization with a higher than fair market value rate of interest; and
- Loan by a tax-exempt organization with less than fair market value rate of interest

To illustrate: Alice Brown is the Executive Director of Children's Future, a 501(c)(3) corporation. After reviewing a compensation study, the board determines that similar tax-exempt organizations pay executives with skills and experience like Alice's between $50,000 and $100,000. The board resolves to compensate Alice with an annual salary of $70,000, with a $500 bonus for each new student who joins the program. In 2019, 200 new students join the

[2] IRC § 4958(c)(1).

program. Alice receives $170,000 in compensation – at least $70,000 in excess of the highest estimate of the fair market value of her services. As a result, Alice received an excess benefit of about $70,000.

Fair Market Value

What is "fair market" value? The IRS specifically defines fair market value as the price at which two willing and informed parties would exchange property in a free market:

> *The value of property, including the right to use property…is the fair market value (i.e., the price at which property or the right to use property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell or transfer property or the right to use property, and both having reasonable knowledge of relevant facts).* [3]

Disqualified Person

Both natural persons and business entities can be disqualified persons.

The IRS definition of "disqualified person" refers to a person who has power over a tax-exempt organization. [4] These "disqualified persons" are held to a high standard to ensure they do not use that power to bend the organization's activities for the disqualified persons' own economic gain.

Natural persons are disqualified either: (1) directly, because of their substantial influence over an organization; or, (2) indirectly, due to their close relationship to a person of substantial influence, such as family members related by blood or marriage to a disqualified person. [5]

Business entities[6] are treated as disqualified persons if a disqualified person, and/or his or her family members, own more than 35% of the organization's interest or, in an organization governed by members or a board, 35% of the voting power. [7]

For example, if a tax-exempt organization's director has a 40% ownership in a construction company, that company itself is a disqualified person with respect to the tax-exempt organization. The tax-exempt organization may still choose to hire the construction company to remodel the organization's facility. However, beforehand, the tax-exempt

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[3] Treas. Reg. §53.4958-4(b)(1)(i).

[4] IRC § 4958(f)(1)

[5] Treas. Reg. §53.4958-3(b)(1) (Family members are defined as: Spouse, Brothers or sisters (by whole or half-blood), Spouses of brothers or sisters (by whole or half-blood), Ancestors, Children, Grandchildren, Great grandchildren, and Spouses of children, grandchildren, and great grandchildren.)

[6] These entities are corporations, partnerships, trusts or estates.

[7] Treas. Reg. §53.4958-3(b)(2)(i)(A)-(C)

organization should conduct and document its due diligence to avoid an EBT in fact or appearance. The IRS has issued guidance describing the diligence that should take place.[8]

Substantial Influence

To clarify the regulations, the IRS also specifically defines "substantial influence."

The IRS identifies two circumstances in which a person has substantial influence which would make the person disqualified: (1) substantial influence is given to him or her as a function of his or her position or relationship to an organization; or, (2) substantial influence results from special facts or circumstances surrounding the person's connection to the organization. [9]

Examples of positions or relationships which likely involve substantial influence are presidency, executive office, voting directorship, and financial office. Examples of persons in special facts or circumstances which lead to substantial influence include founders, substantial contributors, and individuals with financial interests in the tax-exempt organization's affairs. An example of these financial interests is compensation computed based on revenue or control over spending for an organization or a department.

Example

To see how these terms come together, consider this example. Arthur Smith is the Executive Director of A Better World, a tax-exempt organization. Arthur is also the sole proprietor of a private web design business called Arthur's Web Design. Arthur is married to Betty. A Better World, NFP needs to hire a website design firm. Arthur, in his capacity as Executive Director of A Better World, hires Arthur's Web Design to perform the work. A Better World pays Arthur's Web Design twice the industry's customary rate for the services. Meanwhile, Betty uses A Better World's credit card for about $500 for incidental expenses, including receipts for family dinners out and a few clothing retailers. In this case, Arthur is a disqualified person because Arthur's position gives him substantial influence over A Better World's activities. As a close relative of Arthur through marriage, Betty is also disqualified and will be subject to the tax on EBTs for her credit card purchases. Arthur's Web Design is a disqualified entity because a disqualified person – Arthur – owns 100% of the entity and is subject to the tax on EBTs for one-half of the amount paid for services.

Organization Manager

[8] See page 5 of this whitepaper, as well as Part III of this series, *Best Practices with Respect to Excess Benefit Transactions*, for more information.
[9] Treas. Reg. §53.4958-3(c)

An organization manager is any officer, director, or trustee of a tax-exempt organization, or any individual having powers or responsibilities similar to those of officers, directors, or trustees of the organization, regardless of title. Organization managers are subject to a special standard of conduct and, are subject to an excise tax if they so much as participate in an EBT, even if the organization manager does not personally receive any improper benefit.

In determining whether an organization manager is subject to penalties for an EBT occurring at his or her organization, the IRS evaluates the organization manager's participation in the transaction, his or her knowledge of the transaction, and his or her willfulness in participating in the transaction. However, if an organization manager opposes the proposed EBT, he or she is not considered to have participated in it and will not be subject to the tax on EBTs. [10]

The Safe Harbor: Protective Measures for Organization Manager to Prevent an EBT

Most organization managers do not want to violate the regulations regarding EBTs but may not know how best to avoid these situations. The IRS has developed a "safe harbor" for organization managers who follow certain precautions before entering potentially conflicted transactions.

1. ***Reliance on Professional Advice.*** If full disclosure of the facts of a proposed transaction are made to a professional with expertise in that area, such as an attorney or accountant, the organization manager will not be treated as knowingly participating in an EBT if he or she relied on the professional's reasoned written opinion. [11]

2. ***Rebuttable Presumption of Reasonableness***. If organization managers are considering a proposed compensation arrangement or transaction and want to protect themselves from a tax on EBTs, they can follow a three-step procedure outlined in the regulations. [12] This concept is explored in more detail in Part III of this series, but an overview is included here for ease of reading. This three-step process creates what is often referred to as the "rebuttable presumption of reasonableness." If the following conditions are satisfied, then payments under a compensation arrangement are presumed to be reasonable, and a transfer of property, or the right to use property, is presumed to be at fair market value.[13]

    a. The compensation arrangement or the transaction is approved in advance by the governing body or a committee acting on behalf of the governing body

[10] Treas. Reg. § 53.4958-1(d)(3)
[11] Treas. Reg. § 53.4958-1(d)(4)(iii)
[12] Treas. Regulation §53.4958-6
[13] Treas. Reg. § 53.4958-6(a)

and composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement or transaction.[14]

b. The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination that the compensation arrangement in its entirety is reasonable or the property transfer is at fair market value;[15] and

c. The authorized body adequately documented the basis for its determination concurrently with making that determination.[16]

If all three steps are met at the time the parties enter into the contract or transaction,[17] the burden of proof shifts to the IRS to show that the transaction was not reasonable. The IRS may overcome the burden of proof only if it develops sufficient contrary evidence to discredit the comparability data relied upon by the decision makers.[18]

3. ***Expressing Dissent for Transaction.*** If an organization manager believes the proposed transaction could be an EBT, he or she voices an opposition to it, and it is later determined to be an EBT, the dissenting organization manager will not be subject to the excise tax on EBTs, even if the other organization managers are. The organization manager may want to memorialize his or her dissent in the board minutes or in a letter to the board chair.

Understanding the Importance: Calculating the Penalties for a Violation[19]

Historically, the general regulations prohibiting private benefit and private inurement focused the penalties for violations on the tax-exempt organization itself. To create a greater personal incentive for compliance, the IRS imposes penalties for EBTs on the violators themselves.

1. ***First-Tier Tax on Disqualified Person***. A 25% excise tax is imposed on any disqualified person who engages in an EBT with the tax-exempt organization.[20] Stated another way, a disqualified person who receives an excess benefit from a transaction is liable for a tax equal to 25% of the amount of the excess benefit.

2. ***First-Tier Tax on Organization Manager.*** A 10% excise tax is imposed on any organization manager that participated in the EBT, knowing that it was an EBT,

[14] Treas. Reg. § 53.4958-6(a)(1)
[15] Treas. Reg. § 53.4958-6(a)(2)
[16] Treas. Reg. § 53.4958-6(a)(3)
[17] Treas. Reg. § 53.4958-6(f)
[18] Treas. Reg. § 53.4958-6(b)
[19] For a real-life example of excess benefit taxes, see this Journal of Accountancy article from May 2018.
[20] IRC § 4958(a)(1)

unless this manager's participation was not willful and is due to reasonable cause.[21] The term "organization manager" includes board members. The maximum amount of tax imposed on organization managers for a single EBT is $20,000.[22] Any manager who is found to have participated in the EBT is liable for the tax.

3. ***Second-Tier Tax on Disqualified Persons***. If a first-tier tax has been imposed on a disqualified person and he or she has not corrected or repaid the excess benefit in full before the IRS mails the notice of deficiency or the date the IRS assesses the first-tier tax on the disqualified person, then a second-tier tax is imposed on the disqualified person equal to 200% of the amount of the excess benefit.[23]

   If more than one person is liable for the first- or second-tier tax, all persons shall be jointly and severally liable for the tax.[24]

   If an organization manager receives the excess benefit, he or she can be subject to both the first and second tier tax. [25]

4. ***Additional Penalty.*** If any person is liable for the excise tax on EBTs and their act or failure to act is not due to reasonable cause, then a penalty equal to the amount of the excise tax on EBTs will be imposed if this person has either previously been liable for a tax on EBTs or this person's act or failure to act is both willful and flagrant. [26] For example, if a person is subject to the 200% tax on EBTs and his actions were both willful and flagrant, then an additional 200% tax can be imposed under IRC §6684 for a total tax of 400%. A willful and flagrant act (or failure to act) is one which is voluntarily, consciously, and knowingly committed in violation of the EBT statute and which appears to a reasonable man to be a gross violation. [27]

5. ***Other Penalties and Revocation.*** The IRS has the authority to revoke the organizations tax-exempt status and/or impose the penalties above.

Under certain circumstances, these penalties may be reduced or abated. Penalty correction and abatement will be discussed in Part IV of this series.

General Best Practices

In addition to the "safe harbor" for organization managers and the protective steps described above, the best practices with respect to avoiding EBTs follow closely with those outlined in

[21] IRC § 4958(a)(2)
[22] IRC § 4958(d)(2)
[23] IRC § 4958(b)
[24] IRC § 4958(d)(1)
[25] Treas. Reg. § 53.4958-1(a)
[26] IRC § 6684; Treas. Reg. §301.6684-1
[27] Treas. Reg. § 1.507-1(c)(2)

the preceding whitepaper, which addressed general best practices for avoiding improper private benefit.

1. **Education.** Leaders of religious organizations should educate the organization's directors, finance council, officers, and employees about EBTs, the consequences of violations, and the importance of compliance.

2. **Prevention.** Religious organizations should have a conflict of interest policy, which directors, officers, and key employees should review and sign annually. The policy should set forth protocol for board review of any transaction that may involve a benefit to an interested person. The IRS publishes an example policy, which can be adapted to fit a religious organization's needs.

   The board of directors should also draft a list of transactions which require the pre-approval of the board, to avoid violations or the appearance of violations. The list should address the organization's typical operations. Some examples might include contracts with an interested person and contracts above a certain threshold of value; loans; compensation; and rental contracts.

3. **Diligence.** When making decisions, particularly those involving an interested person, the board should conduct its due diligence to determine what options are available and what options would best serve the organization. For example, when considering hiring a construction firm to renovate a facility, the board should solicit quotes from several firms. The board is not obligated to choose the least expensive option; but the board should make a choice which is fair, reasonable, and in the best interests of the organization. The board should also describe, in writing, what factors led to its choice of one contractor over another.

   In the context of transactions which are particularly high value or high profile, the leadership should consider having an outside opinion, such as from a law firm, consulting firm, or accountant, to assess the available options and make recommendations to the board.

4. **Documentation.** For decisions involving interested persons, as well as any other key financial decisions, the board should document its diligence in a written resolution indicating the background and research done, the board's reasoning, and the board's conclusion. The resolution need not be exhaustive; typically five to ten sentences describing the context and the decision are adequate. The resolution should be saved in the corporate records, in case the decision is later challenged.

It is important to remember that tax-exemption does not mean exemption from all tax compliance responsibilities. Understanding and avoiding EBTs is critical for tax-exempt organizations and their leaders. With proper education and processes in place, organizations can be confident both in their compliance with the tax code and in their freedom to focus on the organization's religious mission.

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