Best Practices with Respect to Excess Benefit Transactions

Part III 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. The second whitepaper explained a specific type of private inurement issue, the excess benefit transaction (EBT). The second whitepaper also described how to avoid an EBT and what the consequences are if an EBT takes place. This third whitepaper provides best practices for avoiding excess benefit transactions: (1) using the rebuttable presumption of reasonableness; (2) avoiding automatic excess benefit transactions; and (3) being aware of exceptions to excess benefit transactions.

Best Practices for Avoiding Excess Benefit Transactions

1. Develop and implement a procedure to establish the "rebuttable presumption of reasonableness" before entering potentially conflicted transactions.
2. Avoid giving informal compensation to disqualified persons and organization managers, as these economic benefits will be automatically considered excess benefits if not properly reported.
3. Note that the IRS disregards some fringe benefits when evaluating whether an excess benefit transaction occurred.
4. Ask an attorney or accountant to assist with specific questions, particularly in ambiguous areas.

Addressing Conflicted Transactions and Avoiding Excess Benefit Transactions

As discussed in the prior whitepapers in this series, conflicted transactions arise naturally in the lifecycle of a tax-exempt organization. Disqualified persons often have the resources to offer discounted services and products to the tax-exempt organization. [2] With the best

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[2] As defined in the Part II of this four-part series of whitepapers, a person is disqualified if (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

intentions, disqualified persons are often eager to share these discounts, seeking to minimize the organization's expenses and thereby further the organization's mission.

For example, in a common scenario, a tax-exempt organization's director owns a separate, for-profit construction company. The director would like the construction company to assist the tax-exempt organization in needed renovation. Accordingly, the director offers his firm's service at below-market rates to complete the job.

The conflict here is clear, but that does not mean the organization must turn down the opportunity. The Internal Revenue Service (IRS) issued guidance to allow organizations to enter such transactions without fear of violating tax law, provided certain procedures are carefully observed. If the procedures are followed, the IRS and other authorities will assume that the transaction was fair and reasonable, rather than improperly or excessively beneficial to a private party.

The Rebuttable Presumption of Reasonableness

There are three steps required to establish the presumption that an otherwise conflicted transaction was not an excess benefit transaction, but, in fact, was fair and reasonable for the tax-exempt organization.

1. **Research.** Before entering into a compensation arrangement, purchasing property from, or otherwise entering a payment arrangement with a disqualified person (including payment to the construction company in the example above), the board of directors, or other authorized decision-making body, should gather data about comparable offers for the same services or products. [3] For example, if the board is considering a compensation arrangement, the board should obtain information about:
    a. Compensation levels at similar positions and similar organizations;
    b. Compensation studies done by third parties; and

connection to the organization. Close relatives of disqualified persons are also disqualified, as are businesses in which disqualified persons have more than 35% ownership. See IRC § 4958(f)(1).

[3] An authorized body means: (1) the governing body (i.e., the board of directors, board of trustees, or equivalent controlling body) of the organization (Treas. Reg. § 53.4958-6(c)(1)(i)(A)); (2) A committee of the governing body, which may be composed of any individuals permitted under State law to serve on such a committee, to the extent that the committee is permitted by State law to act on behalf of the governing body; (Treas. Reg. § 53.4958-6(c)(1)(i)(B)); or (3) To the extent permitted under State law, other parties authorized by the governing body of the organization to act on its behalf by following procedures specified by the governing body in approving compensation arrangements or property transfers. (Treas. Reg. § 53.4958-6(c)(1)(i)(C)). An individual is not included on the authorized body when it is reviewing a transaction if that individual meets with other members only to answer questions, and otherwise recuses himself or herself from the meeting and is not present during debate and voting on the compensation arrangement or property transfer (Treas. Reg. § 53.4958-6(c)(1)(ii)). Note that this whitepaper only discusses matters of federal tax law. State corporate laws regarding approval of conflicted transactions differ from state to state.

c. Other, written offers received by the disqualified person. [4] [5]

Most tax-exempt organizations publish key compensation information in the organization's annual Form 990. The Form 990s are publicly available through Candid (formerly called "GuideStar") and the IRS website.

Similarly, an exempt organization considering the purchase of property owned by a disqualified person should conduct research to assess the fair market value of the property, including:

a. Current, third-party appraisals of the property; and
b. Other offers the property seller received in an open bidding process. [6]

2. **Decision.** When the board discusses and votes on the proposed transaction, all conflicted parties should be recused.[7] The board minutes meetings should expressly note who was recused and why.

3. **Documentation.** The board should carefully document the research conducted and the basis for the board's ultimate decision. The board can consider more than one factor in making the selection; the board is not obligated to simply choose the lowest bidder.

   Specifically, the board minutes should include the following details about the transaction: [8]

   a. The terms of the transaction;
   b. The date the transaction was approved;
   c. The directors who were present for the discussion of and vote on the transaction;
   d. The research done regarding comparable transactions;
   e. The source of that research;
   f. Whether the conflicted parties were properly recused from the discussion and vote; and
   g. The basis for the board's ultimate decision. Note that, in the case of a religious organization, there may be additional religious factors that influence the board's decision.

[4] Treas. Reg. § 53.4958-6(c)(2)(i).
[5] For non-fixed payments without a cap, the rebuttable presumption of this section arises only after the exact amount of the payment is determined, or a fixed formula for calculating the payment is specified, and the three requirements for the presumption are subsequently satisfied. Treas. Reg. § 53.4958-6(d)(1).
[6] Treas. Reg. § 53.4958-6(c)(2)(i).
[7] Treas. Reg. § 53.4958-6(c)(1)(iii)(A)-(E).
[8] Treas. Reg. § 53.4958-6(c)(3)(i).

Continuing the previous example, if the board wishes to consider hiring the director's construction firm, the board should first obtain written quotes from other area construction firms. The board should then meet and discuss the available options, with the conflicted director absent from both the discussion and the vote. Once the board has made its decision, the basis for the board's choice should be articulated and included in the minutes. The description of the choice does not need to be exhaustive but should be adequate to cover the highlights of the decision. The minutes should be dated and kept in the corporate records.

Avoiding Automatic Excess Benefit Transactions

In addition to the steps described above, tax-exempt organizations should also protect themselves from **automatic excess benefit transactions** by avoiding informal economic benefits to disqualified persons. [9] Automatic excess benefit transactions occur when a tax-exempt organization provides an economic benefit to a disqualified person without properly recording the transaction. Embezzlement and theft are always treated as an automatic EBT.

More innocent transactions can also result in an automatic EBT. Consider an example in which a school board, pleased with the school principal's performance, awards the principal a car, donated by one of the directors. Neither the school board nor the principal reports the car as compensation, as the car was an informal "gift," not part of the formal compensation package. Unfortunately, the transaction is likely an automatic EBT in the eyes of the IRS.

If a tax-exempt organization wishes to provide an economic benefit to a disqualified person as part of the person's reasonable compensation, the benefit must be reported as compensation on Form 1099 or W-2 and/or on the organization's IRS Form 990 and on the recipient's Form 1040.

Without the required reporting, the economic benefit will be considered an excess benefit, even if its value would not result in the disqualified person receiving more than reasonable compensation for his or her services.

Exceptions to Excess Benefit Transactions

Most, but not all, economic benefits are considered in determining whether an excess benefit transaction has occurred. [10] However, the IRS has identified specific economic benefits which the IRS disregards for purposes of evaluating excess benefit transactions. For example, expense reimbursements are generally not considered as potential excess benefit transactions if they are paid under an "accountable plan," a technical term which means the expense has a business connection, it meets certain substantiation requirements, and any excess

[9] Treas. Reg. § 53.4958-4(c)(1).
[10] Treas. Reg. § 53.4958-4(a)(4); Treas. Reg. §1.62-2(c)(2); IRS Publication 463.

reimbursement is returned. [11] Nontaxable fringe benefits are not treated as part of an excess benefit transaction. Benefits to a person who is a member of the class of persons served by the tax-exempt organization (e.g., a veterans' organization providing a benefit to a veteran) are not considered potential excess benefit transactions. Similarly, small benefits provided to volunteers are not considered excess benefits if the same opportunity is available to the general public for purchase at $75 or less annually.

Conclusion

With proper procedures in place, exempt organizations can proceed with confidence that excess benefit transactions will not jeopardize the organization's good standing with the IRS.

Before entering potentially conflicted transactions, an exempt organization should conduct the research, independent decision-making, and documentation required to meet the IRS standard for the presumption of reasonableness.

Organizations should avoid informal grants of economic benefits to disqualified persons to avoid inadvertently creating automatic excess benefit transactions.

Finally, if an organization's leaders are uncertain whether a prospective transaction, economic benefit, or fringe benefit may create an excess benefit transaction, the organization should work with an attorney or accountant to address the specific issue before any problems arise.

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[11] Treas. Reg. § 53.4958-4(a)(4)(ii); for more information about "accountable plans," see IRS Publication 535, p 43.