Intermediate Sanctions (IRC 4958) Update

By Lawrence M. Brauer and Leonard J. Henzke

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Overview

Purpose

This article will describe the principal changes in the final regulations under IRC 4958 and will discuss several key issues in these regulations.

Introduction

The enactment of IRC 4958 was the most important change in the federal income tax law relating to tax-exempt organizations in 30 years. The purpose of IRC 4958 is to impose sanctions on the influential persons in charities and social welfare organizations who receive excessive economic benefits from the organization, rather than to punish the exempt organization itself.

- On January 23, 2002, final regulations interpreting IRC 4958 were published in the Federal Register, 67 F.R. 3076. See also 2002-7 I.R.B. 500 (2/19/02). The final regulations replace temporary regulations published on January 10, 2001 and clarify several provisions in the temporary regulations that were ambiguous. The final regulations make few substantive changes to the temporary regulations. However, there are a number of key issues in the final regulations that are important for agents to consider when conducting IRC 4958 examinations.

Other CPE Articles

Other CPE articles that also discussed IRC 4958 are:

- "Section 4958 Update," FY 2000 EO CPE 21.
- "An Introduction to I.R.C. 4958 (Intermediate Sanctions)," FY 2002 EO CPE 259.

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Overview, Continued

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Administrative Procedures

Technical Advice

During the past few years, most IRC 4958 cases have been either settled or otherwise resolved administratively, without the need for a formal technical advice memorandum.

- In examinations raising IRC 4958 issues, before preparing a request for technical advice, the Group Manager or agent should contact one of the persons listed below in Rulings and Agreements, Washington, D.C. Group Managers and agents are encouraged to contact one of these persons as early as possible in the examination process.

Leonard Henzke	(202) 283-8865
Charles Barrett	(202) 283-9485
Debra Kawecki	(202) 283-9486
Larry Brauer	(202) 283-9457

- One of these persons will discuss the case informally with the caller and attempt to answer the caller's questions. In some cases, the caller may be able to resolve most, if not all, of the issues based on an informal discussion. In other cases, the caller may be asked to send a brief, informal, written submission so that the contact can better address the caller's questions.

- Where the issues are significant or the cases especially difficult, the caller will be asked to submit a request for technical advice.

- Recently, Rulings and Agreements, Washington, D.C., has issued two technical advice memoranda addressing many of the IRC 4958 issues listed on the following page.

Recent Cases

Brief Description

Some of the IRC 4958 issues that Group Managers and agents have discussed with Rulings and Agreements, Washington, D.C., and some of the issues that have been addressed in technical advice memoranda, are:

- Whether disqualified persons have compensation packages from IRC 501(c)(3) organizations that may be unreasonable.
- Whether disqualified persons have received from IRC 501(c)(3) organizations substantial reimbursements of personal expenses.
- Whether disqualified persons use vehicles owned by IRC 501(c)(3) organizations for personal reasons.
- Whether disqualified persons use real property owned by an IRC 501(c)(3) organization for personal reasons; and whether for-profit corporations controlled by disqualified persons use real property owned by an IRC 501(c)(3) organization.
- Whether disqualified persons lease property they own to IRC 501(c)(3) organizations in return for excessive rent.
- Whether amounts received by disqualified persons from IRC 501(c)(3) organizations are loans made by the organization to the disqualified persons.
- Whether amounts received by disqualified persons from IRC 501(c)(3) organizations are the repayment of loans, plus interest, previously made by the disqualified persons to the organization.
- Whether an IRC 501(c)(3) organization confers economic benefits on a disqualified person where such person authorizes the organization to pay for personal expenses of members of the person's family.
- Whether a disqualified person receives economic benefits when an IRC 501(c)(3) organization controlled by the disqualified person pays expenses of a for-profit corporation owned by the disqualified person.
- Whether an employee of an IRC 501(c)(3) organization receives economic benefits when the organization publishes a book and the royalties are received by the employee, but not as compensation.

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Recent Cases, Continued

Issues are Discussed in this Article

Many of these IRC 4958 issues are discussed further in this article.

Caracci v. Commissioner

The first reported case decided under IRC 4958 was Caracci v. Commissioner, 118 T.C. No. 25 (2002).

Caracci v. Commissioner – Facts

Members of a family controlled three home health care organizations that were exempt under IRC 501(c)(3). For business reasons, the family members decided to convert these organizations to for-profit status by transferring all of the assets of each of organization to three for-profit corporations owned by the family members in exchange for the corporations' assumption of the organizations' liabilities.

- The Service determined that the fair market value of the transferred assets substantially exceeded the zero consideration the organizations received in return.

- The Service determined that this excess was an excess benefit transaction under IRC 4958 to each of the family members, who were all disqualified persons.

- The Service also revoked the IRC 501(c)(3) exemption of each organization because the transfers resulted in the organizations being operated for substantial nonexempt purposes, they constituted prohibited inurement, and they impermissibly benefited private interests.

- The taxpayers argued that the fair market value of the assets was substantially less than the value determined by the Service. Since the liabilities assumed by the three corporations exceeded this lower valuation, the net value of the assets transferred was negative. Therefore, none of the family members received any excess benefit from the transfer.

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Recent Cases, Continued

Caracci v. Commissioner – Decision (IRC 4958)

- The Tax Court accepted the Service's valuation of the organizations' assets but with several modifications, resulting in a net value of the assets transferred of $5,164,000.
- The Tax Court concluded that by transferring the assets of the three IRC 501(c)(3) organizations to for-profit corporations that they owned, the family members, who were disqualified persons as to each of the organizations, had received excess benefits under IRC 4958 of $5,164,000 and were liable for the first and second tier excise taxes under IRC 4958.

Caracci v. Commissioner – Decision (Revocation)

- The Tax Court concluded that revocation of the organizations' exemptions under IRC 501(c)(3) was not appropriate because the IRC 4958 excise taxes are being imposed; since the asset transfers to the corporations, the organizations did not operate contrary to the tax-exempt purpose; and retaining the organizations' status as tax-exempt would enable them to be utilized for correction.
- As of the date this article was submitted for publication, the Government has not determined whether to file an appeal.

Applicable Tax-Exempt Organization – Governmental Unit or Affiliate

In General

An applicable tax-exempt organization is an organization described in either IRC 501(c)(3) or IRC 501(c)(4) and exempt from tax under IRC 501(a).

- However, a private foundation, as defined in IRC 509(a), is not an applicable tax-exempt organization.
- An applicable tax-exempt organization includes any organization that was described in either IRC 501(c)(3) or IRC 501(c)(4) and was exempt from tax under IRC 501(a) at any time during a five-year period ending on the date of an excess benefit transaction.
    - This period is referred to as the "Lookback Period." Reg. 53.4958-2(a)(1).

Governmental Unit or Affiliate

A governmental unit or an affiliate of a governmental unit is not an applicable tax-exempt organization if it is:

1. Exempt from (or not subject to) taxation without regard to section 501(a); or
2. Relieved from filing an annual return under Reg. 1.6033-2(g)(6). Reg. 53.4958-2(a)(2)(ii).
    - Rev. Proc. 95-48, 1995-2 C.B. 418, describes government units or affiliates of a government unit that are relieved from filing an annual return under Reg. 1.6033-2(g)(6).

Not Subject to IRC 4958

Therefore, transactions between a person and a governmental unit or an affiliate of a governmental unit, which is relieved from filing an annual return under Rev. Proc. 95-48, are not subject to IRC 4958.

Disqualified Persons

In General

A person is a disqualified person as to an applicable tax-exempt organization if the person was in a position to exercise substantial influence over the affairs of the organization at any time during the five-year period ending on the date of the excess benefit transaction (the "Lookback Period"), but not before September 14, 1995. Reg. 53.4958-3(a)(1).

Automatic Disqualified Persons

Certain persons are automatically disqualified persons. Reg. 53.4958-3(b).

Disqualified Persons Based on Powers and Responsibilities

A person who holds certain powers, responsibilities, or interests as to an applicable tax-exempt organization, regardless of the person's title, is in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization. Reg. 53.4958-3(c).

Persons Not Disqualified Persons

Certain persons are deemed not to be in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization. Reg. 53.4958-3(d).

Based on Facts and Circumstances

In determining whether any other person is a disqualified person as to an applicable tax-exempt organization, agents should consider all relevant facts and circumstances.

- Some of the relevant facts and circumstances tending to show that a person has substantial influence over the affairs of an organization are included in Reg. 53.4958-3(e)(2).

- Some of the relevant facts and circumstances tending to show that a person does not have substantial influence over the affairs of an organization are included in Reg. 53.4958-3(e)(3).

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Disqualified Persons, Continued

In a Position to Exercise Substantial Influence

In considering all the relevant facts and circumstances to determine whether a person is a disqualified person as to an applicable tax-exempt organization, it is not required that a person actually exercised substantial influence over the affairs of an organization, only that the person was in a position to exercise substantial influence.

- Thus, although a person may not have actually exercised substantial influence over the affairs of the organization, if the person was in a position to do so at any time during the Lookback Period, this person is a disqualified person as to the organization.

Example

On March 24, 2002, an individual enters into an excess benefit transaction with an IRC 501(c)(3) organization. If at any time from March 24, 1997 through March 24, 2002, this individual was in a position to exercise substantial influence over the affairs of the organization, this person would be treated as a disqualified person as to this organization on March 24, 2002.

Excess Benefit Transactions – Expense Reimbursements

In General

In determining whether an excess benefit transaction has occurred, all consideration and benefits exchanged between a disqualified person and the applicable tax-exempt organization and all entities the organization controls are taken into account. Reg. 53.4958-4(a)(1).

Benefits Disregarded

However, certain economic benefits are disregarded for purposes of IRC 4958. Reg. 53.4958-4(a)(4).

Nontaxable Fringe Benefits

Virtually all economic benefits that are excluded from income under IRC 132 are disregarded for purposes of IRC 4958. Reg. 53.4958-4(a)(4)(i).

Expenses Reimbursed Under an Accountable Plan

Reimbursements of expenses incurred by a disqualified person, paid by an applicable tax-exempt organization to the disqualified person, are disregarded under IRC 4958 if the expense reimbursements are made under an arrangement that qualifies as an "accountable plan" under Reg. 1.62-2(c)(2). Reg. 53.4958-4(a)(4)(ii).

- This provision ensures that payments for bona fide business expenses, whether the organization pays them directly or the disqualified person pays the expenses and then is reimbursed by the organization, will be treated the same.

Expenses Reimbursed Under a Non-Accountable Plan

Reimbursements of expenses incurred by a disqualified person, paid by an applicable tax-exempt organization to the disqualified person under an arrangement that is a "nonaccountable plan" under Reg. 1.62-2(c)(3), are ordinarily treated as excess benefits. Reg. 53.4958-4(a)(1).

- However, if the organization intended the reimbursement of expenses to be additional compensation, and the contemporaneous substantiation requirements in Reg. 53.4958-4(c)(3) have been satisfied, these payments would be aggregated with the other compensation received by the disqualified person to determine whether the total compensation the disqualified person received was reasonable. Reg. 53.4958-4(b)(1)(ii)(B)(3).

Excess Benefit Transactions - Loans

In General

An excess benefit transaction is any transaction in which an economic benefit is provided by an applicable tax-exempt 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 the consideration received for providing the benefit. Reg. 53.4958-4(a)(1).

- The value of the consideration received for providing the benefit includes the performance of services. Reg. 53.4958-4(a)(1).
- To determine whether an excess benefit transaction has occurred, all consideration and benefits (except certain economic benefits that are disregarded under Reg. 53.4958-4(a)(4)) exchanged between a disqualified person and the organization (and all entities it controls) are taken into account. Reg. 53.4958-4(a)(1).
    - Except for "disregarded benefits," compensation for determining reasonableness under IRC 4958 includes all economic benefits provided by an organization in exchange for the performance of services. These benefits include all compensatory benefits, whether or not included in gross income for income tax purposes, including the economic benefit of a below-market loan. Reg. 53.4958-4(b)(1)(ii)(B)(3).

Loans from Organization to Disqualified Person

A disqualified person may contend that payments made by the applicable tax-exempt organization to the disqualified person were loans.

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Excess Benefit Transactions – Loans, Continued

Loans from Organization to Disqualified Person – Below-Market

If an agent determines that an applicable tax-exempt organization had made bona fide loans to the disqualified person, the agent should determine whether the interest rate on the loans was <u>below</u> market value.

- Under IRC 7872(e)(1), a loan made by the organization to the disqualified person is a below-market loan if:

  (A) In the case of a demand loan, interest is payable on the loan at a rate less than the applicable Federal rate, or

  (B) In the case of a term loan, the amount loaned exceeds the present value of all payments due under the loan.

- The agent should apply IRC 7872 regardless of whether IRC 7872 otherwise applies to the loan. Reg. 53.4958-4(b)(ii)(2)(B)(3).

- The economic benefit of a below-market loan to a disqualified person is the amount that is deemed transferred by the organization to the disqualified person under IRC 7872(a) or IRC 7872(b), regardless of whether IRC 7872 otherwise applies to the loan. Reg. 53.4958-4(b)(1)(ii)(B)(3).

Loans from Disqualified Person to Organization

A disqualified person may contend that payments made by the applicable tax-exempt organization to the disqualified person were repayments by the organization of loans (plus interest) previously made by the disqualified person to the organization.

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Excess Benefit Transactions – Loans, Continued

Loans from Disqualified Person to Organization – Above-Market

If an agent determines that a disqualified person had made bona fide loans to an applicable tax-exempt organization, the agent should determine whether the interest rate on the loans was above market value.

- The agent should apply IRC 7872 regardless of whether IRC 7872 otherwise applies to the loan. Reg. 53.4958-4(b)(ii)(2)(B)(3).

- If the agent determines that the interest rate on the loans was above market value, the disqualified person is treated as having received an economic benefit from the organization equal to the amount of interest received that exceeded market value as determined by applying the standards in IRC 7872, regardless of whether IRC 7872 otherwise applied to the loan.

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Excess Benefit Transactions – Loans, Continued

Were Payments Bona Fide Loans?

Agents should determine whether the transactions were bona fide loans or some other type of transaction. See, e.g., Rosario v. Commissioner, T.C. Memo. 2002-70.

- Whether a particular transaction actually constitutes a loan is determined upon consideration of all the facts. Fisher v. Commissioner, 54 T.C. 905, 909 (1970).

- For a payment to constitute a loan, when the payments are received, the recipient must intend to repay the amounts and the transferor must intend to enforce payment. Haag v. Commissioner, 88 T.C. 604, 615 (1987), aff'd without published opinion, 855 F.2d 855 (8th Cir. 1988); Beaver v. Commissioner, 55 T.C. 85, 91 (1970).

- In addition, the obligation to repay must be unconditional and not contingent on a future event. United States v. Henderson, 375 F.2d 36, 39 (5th Cir. 1967); Bouchard v. Commissioner, 229 F.2d 703 (7th Cir. 1956), aff'g T.C. Memo. 1954-243; Haag v. Commissioner, 88 T.C. at 616.

- The Tax Court generally has considered a number of criteria for determining the intent of the parties at the time the payments were made. Dean v. Commissioner, 57 T.C. 32, 43 (1971). No single factor, standing alone, is controlling, but each factor is considered with all the facts and circumstances present. Id. at 44.

- Greg R. Vinikoor v. Commissioner, T.C. Memo. 1998-152, states:

  > The determination of whether a transfer was made with a real expectation of repayment and an intention to enforce the debt depends on all the facts and circumstances including whether:
  >
  > (1) There was a promissory note or other evidence of indebtedness;
  > (2) Interest was charged;
  > (3) There was security or collateral;
  > (4) There was a fixed maturity date;
  > (5) A demand for repayment was made;
  > (6) Any actual repayment was made;
  > (7) The transferee had the ability to repay;
  > (8) Any records maintained by the transferor and/or the transferee reflected the transaction as a loan; and
  > (9) The manner in which the transaction was reported for Federal tax purposes is consistent with a loan.

Excess Benefit Transactions – Examinations

In General

IRC 4958 imposes excise taxes on each excess benefit transaction between an applicable tax-exempt organization and a disqualified person. Reg. 53.4958-1(a).

- An excess benefit is the amount by which the value of the economic benefit provided by an organization directly or indirectly to or for the use of any disqualified person exceeds the value of the consideration (including the performance of services) received for providing such benefit. Reg. 53.4958-1(b).

All Excess Benefit Transactions

- Congress intended that IRC 4958 apply to all excess benefit transactions, not just those considered abusive. H.R. Rep. No. 104-506, 104th Cong., 2d Sess. 53. (1996).

- Agents should raise IRC 4958 issues in all situations involving excess benefit transactions between an organization and a disqualified person, not just those considered abusive.

Form 990

- IRC 501(c)(3) and IRC 501(c)(4) organizations are required to report annually certain information regarding excess benefit transactions under IRC 4958. IRC 6033(b)(11); IRC 6033(b)(12); IRC 6033(b)(13); IRC 6033(f); Regs. 1.6033-2.

- IRC 501(c)(3) organizations are required to report other information the Service may require for purposes of carrying out the internal revenue laws. IRC 6033(b)(14); Regs. 1.6033-2(i)(2).

- Form 990, Part VI, Question 89b, and Form 990-EZ, Part V, Question 40b ask:

  > *501(c)(3) and 501(c)(4) orgs*. Did the organization engage in any section 4958 excess benefit transaction during the year or did it become aware of an excess benefit transaction from a prior year? If "Yes," attach a statement explaining each transaction.

- The Instructions for Form 990 Question 89b and Form 990-EZ Question 40b state:

  > Attach a statement describing any excess benefit transaction, the disqualified person or persons involved, and whether or not the excess benefit transaction was corrected.

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Excess Benefit Transactions – Examinations, Continued

Form 990 – Question 89b

Agents conducting examinations of IRC 501(c)(3) or IRC 501(c)(4) organizations should determine whether Question 89b on Form 990 (or Question 40b on Form 990-EZ) was answered "Yes." If it was, agents should review the statements attached to the organizations' Form 990 (or Form 990-EZ).

- If Question 89b (or Question 40b) was answered "Yes," but no statement was attached, agents should ask the organizations for the appropriate statements.
- If Question 89b (or Question 40b) was answered "No," "Not Applicable," or not answered, agents should determine whether it should have been answered "Yes." In that case, agents should ask the organizations for the appropriate statements.
- Agents should inspect the organizations' Forms 990 (and Forms 990-EZ) for periods subsequent to the examination years to ascertain whether the organization answered Question 89b (or Question 40b) "Yes" and attached the appropriate statements describing excess benefit transactions during the examination years of which they became aware during the current year.

Checklist

To help agents identify and analyze excess benefit transactions, a checklist entitled "I.R.C. 4958 in Steps" appears in Appendix 1 of the Exempt Organizations CPE text for FY 2002 (pp. 324 to 326).

Compensation – Documenting Intent

In General

An economic benefit is not treated as consideration for the performance of services unless the applicable tax-exempt organization providing the benefit clearly indicates its intent to treat the benefit as compensation when the benefit is paid. Reg. 53.4958-4(c)(1).

- An organization (or entity controlled by the organization) is treated as clearly indicating its intent to provide an economic benefit as compensation for services only if the organization provides written substantiation that is contemporaneous with the transfer of the particular economic benefit.

- If an organization providing economic benefits to a disqualified person fails to provide written contemporaneous substantiation, the economic benefits are treated as excess benefits under Reg. 53.4958-4(c)(1), unless the organization provided the economic benefits in exchange for consideration other than the performance of services.

- For example, if an organization does not provide written contemporaneous substantiation that the value of the personal use by a disqualified person of an automobile owned by the organization was intended to be compensation, this value would ordinarily be treated as an excess benefit under Reg. 53.4958-4(c)(1).

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Compensation – Documenting Intent, Continued

Written Contemporaneous Substantiation – Reporting

One method of providing written contemporaneous substantiation is by the reporting of benefits.

- The organization reports the benefit as compensation on an original Federal tax information return (Form W-2 or Form 1099), or on an amended Federal tax information return filed before the start of an IRS examination of either the organization or the disqualified person for the year when the transaction occurred; or

- The disqualified person reports the benefit as income on the person's original Federal tax return (Form 1040), or on the person's amended Federal tax return filed prior to the earlier of:

  - The start of an IRS examination of either the organization or the disqualified person for the year when the transaction occurred; or

  - The first written documentation by the IRS of a potential excess benefit transaction involving either the organization or the disqualified person. Reg. 53.4958-4(c)(3).

Written Contemporaneous Substantiation – Approval per Established Procedures

Another method of providing written contemporaneous substantiation is that the appropriate decision-making body of the organization or an officer authorized to approve compensation approved a transfer as compensation for services in accordance with "established procedures." Reg. 53.4958-4(c)(3)(ii).

- The IRS will interpret the term "established procedures" to refer to the organization's usual practice for approving compensation, rather than requiring an organization to have a formal written procedure for approving compensation. T.D. 8978, 2002-7 I.R.B. 500, 505 (2/19/02).

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Compensation – Documenting Intent, Continued

Written Contemporaneous Substantiation – Other Forms

Other forms of written contemporaneous substantiation are:

- An approved written employment contract executed on or before the date of transfer.
- Appropriate documentation indicating that an authorized body approved the transfer as compensation for services on or before the date of the transfer.
- Written evidence, that existed on or before the due date of the appropriate Federal tax return (Form W-2, Form 1099 or Form 1040), including extensions but not amendments of the return, of a reasonable belief by the organization that under the Internal Revenue Code, the benefit was excludable from the disqualified person's gross income. Reg. 53.4958-4(c)(3)(ii).

Theft or Fraud

An economic benefit that disqualified person obtains by theft or fraud is not treated as consideration for the performance of services and therefore, is treated as an excess benefit. Reg. 53.4958-4(c)(1).

- This rule is intended to address situations where the organization has suffered a loss of cash or other property that is analogous to a theft loss under IRC 165, or that was due to the fraudulent act of the disqualified person. An agent should determine whether a benefit has been obtained by theft or fraud; a non-tax judicial determination of theft or fraud is not required. The agent's determination is subject to IRS administrative appeal and judicial review.

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Compensation – Property Subject to a Substantial Risk of Forfeiture

In General

An excess benefit transaction is any transaction in which an economic benefit is provided by an applicable tax-exempt 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 the consideration received for providing the benefit. Reg. 53.4958-4(a)(1).

- The value of the consideration received for providing the benefit includes the performance of services. Reg. 53.4958-4(a)(1).

Reasonable Compensation

The value of services is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation).

- IRC 162 standards apply in determining reasonableness of compensation, taking into account the aggregate benefits provided to a person and the rate at which any deferred compensation accrues.
    - The aggregate benefits do not include "disregarded benefits" under Reg. 53.4958-4(a)(4).

Timing of Reasonableness Determination – Fixed Payment

In the case of a fixed payment under a contract, the facts and circumstances to be taken into consideration in determining reasonableness of the fixed payment made by an organization to a disqualified person are those existing on the date the parties enter into the contract under which the payment is made. Reg. 53.4958-4(b)(2)(i).

- A fixed payment is an amount of cash or other property specified in the contract, or determined by a fixed formula specified in the contract, which is to be paid or transferred in exchange for the provision of specified services or property. Reg. 53.4958-4(a)(3)(ii)(A).

Timing of Reasonableness Determination – Non-Fixed Payment

In the case of a non-fixed payment under a contract, reasonableness is determined based on all the facts and circumstances, up to and including circumstances as of the date of payment. Reg. 53.4958-4(b)(2)(i).

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Compensation – Property Subject to a Substantial Risk of Forfeiture, Continued

Property Subject to a Substantial Risk of Forfeiture

These same timing rules also apply to property subject to a substantial risk of forfeiture.

- If property subject to a substantial risk of forfeiture is a fixed payment, reasonableness is determined when the parties entered into the contract providing for the transfer of the property. Reg. 53.4958-4(b)(2)(i).

- If property subject to a substantial risk of forfeiture is not a fixed payment, reasonableness is determined based on all the facts and circumstances up to and including circumstances on the date of payment. Reg. 53.4958-4(b)(2)(i).

Example – Facts

On December 31, 2002, "EO, " an applicable tax-exempt organization, and "DP," a disqualified person as to the organization, entered into a five-year employment contract for the period from January 1, 2003 through December 31, 2007. Under this agreement, in return for the services DP will perform for EO, EO will pay DP a specified annual salary and, if DP completes the five-year term and is not discharged for cause, EO will also pay DP $1 million at the end of the term.

- DP completes his performance under the employment contract, and on January 2, 2008, EO pays DP $1 million.

Example – Conclusion

Whether the compensation EO pays DP each year from 2003 through 2008 is reasonable is determined based on all the facts and circumstances that existed on December 31, 2002. See Reg. 53.4958-4(b)(2)(ii), Example 2.

Compensation – Reasonable Compensation

In General

In determining whether compensation is reasonable, the value of services is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances. IRC 162 standards apply in determining the reasonableness of compensation. Reg. 53.4958-4(b)(1)(ii)(A).

- In determining reasonable compensation, the agent should take into consideration all relevant facts and circumstances including, but not limited to, the following:
  - Compensation levels paid by similarly situated organizations, both taxable and non-taxable, for functionally comparable positions;
  - The availability of similar services in the geographic area of the applicable tax-exempt organization;
  - Current compensation surveys compiled by independent firms; and
  - Actual written offers from similar institutions competing for the services of the disqualified person.

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Compensation – Reasonable Compensation, Continued

Compensation Surveys Compiled by Independent Firms

In considering current compensation surveys compiled by independent firms, the agent should take into account:

- Whether the compensation surveys were performed by reputable firms having knowledge and expertise in the same industry as that of the applicable tax-exempt organization.
- Whether the firms were independent with respect to both the applicable tax-exempt organization and the disqualified person.
- Whether the compensation surveys covered the periods that are the subject of the IRC 4958 examination.
- Whether the organizations included in the compensation surveys were similarly situated.
- Whether the positions considered in the surveys were functionally comparable to the position of the disqualified person.
- The number of compensation surveys and the number of different organizations included in the surveys.

All Economic Benefits are Included

For determining the reasonableness of compensation, all economic benefits provided by an applicable tax-exempt organization in exchange for the performance of services are included, except for economic benefits that are disregarded under Reg. 53.4958-4(a)(4). Reg. 53.4958-4(b)(1)(ii)(B).

Payment or Reimbursement of Expenses

Unless excludable from gross income as a *de minimis* fringe benefit under IRC 132(a)(4), these economic benefits include, for example, the payment or reimbursement by the organization of any expense:

- Not reasonably incurred by the person in connection with a civil judicial or civil administrative proceeding arising out of the person's performance of services on behalf of the organization. Reg. 53.4958-4(b)(1)(ii)(B)(*2*)(*ii*); or
- Any expenses resulting from an act or failure to act as to which the person has acted willfully and without reasonable cause. Reg. 53.4958-4(b)(1)(ii)(B)(*2*)(*iii*).

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Compensation – Reasonable Compensation, Continued

Payment or Reimbursement of Expenses

Unless excludable from gross income as a *de minimis* fringe benefit under IRC 132(a)(4), these economic benefits include, for example, the payment or reimbursement by the organization of any expense:

- Not reasonably incurred by the person in connection with a civil judicial or civil administrative proceeding arising out of the person's performance of services on behalf of the organization. Reg. 53.4958-4(b)(1)(ii)(B)(*2*)(*ii*); or
- Any expenses resulting from an act or failure to act as to which the person has acted willfully and without reasonable cause. Reg. 53.4958-4(b)(1)(ii)(B)(*2*)(*iii*).

Professional Fees

The payment or reimbursement of professional fees by an applicable tax-exempt organization, which relate to an IRC 4958 matter involving a disqualified person or an organization manager, is not included in the person's compensation for determining the reasonableness of compensation under IRC 4958.

- However, the payment or reimbursement of professional fees by an organization, which relate to an IRC 4958 matter involving a disqualified person or an organization manager, and which result from an act or failure to act, as to which the person acted willfully and without reasonable cause, is included in the person's compensation for determining the reasonableness of compensation under IRC 4958.
    - These amounts are combined with the person's other compensatory benefits to determine whether the aggregate compensation is reasonable under IRC 4958.

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Compensation – Reasonable Compensation, Continued

Professional Fees – Example 1 - Facts

- In 2003, the Service conducted an examination of the 2000 and 2001 Forms 990 filed by "EO," an IRC 501(c)(3) organization.
- In 2003, the Service also conducted an IRC 4958 examination of "DP," a disqualified person as to EO, for 2000 and 2001.
- EO and DP each executed separate Forms 2848 (Power of Attorney and Declaration of Representative) authorizing "CPA," a certified public accountant, to represent EO and DP in connection with their respective examinations.
- In 2003, EO paid $10,000 to CPA for professional services in connection with these examinations, $7,500 of which was for services CPA performed for EO and $2,500 of which was for services CPA performed for DP.

Professional Fees – Example 1 - Conclusion

The $2,500 EO paid CPA in 2003 for services CPA performed for DP regarding the IRC 4958 examination of DP is not included in DP's compensation for determining the reasonableness of DP's compensation in 2003 under IRC 4958. Reg. 53.4958-4(b)(1)(B)(*2*)(*ii*).

Professional Fees – Example 2 - Facts

The facts are the same as in Example 1, except that at the conclusion of DP's examination, the Service determined that in 2000, DP received an excess benefit under IRC 4958.

- DP properly completed correction of the excess benefit under Reg. 53.4958-7 and requested that the Service not assert the 25% tax under IRC 4962.
- However, the Service declined because it concluded that DP's entering into the excess benefit transaction was not due to reasonable cause and was due to willful neglect.

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Compensation – Reasonable Compensation, Continued

Professional Fees – Example 2 - Conclusion

The $2,500 EO paid CPA in 2003 for services CPA performed for DP regarding the IRC 4958 examination of DP is included in DP's compensation for determining the reasonableness of DP's compensation in 2003 under IRC 4958. Reg. 53.4958-4(b)(1)(B)(*2*)(*iii*).

- The $2,500 is combined with DP's other compensatory benefits in 2003 to determine whether DP's aggregate compensation in 2003 is reasonable under IRC 4958.

Compensation – Services Performed in Prior Years

In General

An excess benefit transaction is any transaction in which an economic benefit is provided by an applicable tax-exempt 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 the consideration received for providing the benefit. Reg. 53.4958-4(a)(1).

- The value of the consideration received for providing the benefit includes the performance of services. Reg. 53.4958-4(a)(1).

- To determine whether an excess benefit transaction has occurred, all consideration and benefits exchanged between a disqualified person and the organization (and all entities it controls) are taken into account. Reg. 53.4958-4(a)(1).

    - However, economic benefits that are "disregarded" under Reg. 53.4958-4(a)(4) are not taken into account.

    - For example, in determining the reasonableness of compensation that is paid (or vests, or is no longer subject to a substantial risk of forfeiture) in one year, services performed in prior years may be taken into account. Reg. 53.4958-4(a)(1).

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Compensation – Services Performed in Prior Years, Continued

Services Performed in Prior Years

If an agent determines that the disqualified person actually or constructively received, during the examination period, deferred compensation (or deferred compensation became no longer subject to a substantial risk of forfeiture), the agent should determine whether any portion of this compensation was an excess benefit under IRC 4958.

- The agent should determine whether the organization intended for the deferred compensation paid (or which became no longer subject to a substantial risk of forfeiture) in an examination year to constitute consideration for services the person performed for prior years.
    - In that event, the agent should determine the value of the services the person performed for the organization in each of the prior years.
    - If the agent determines that the total compensation the person received (or which became no longer subject to a substantial risk of forfeiture) in an examination year was less than the value of the services the person performed for the organization during the prior years, no excess benefit would have occurred in the examination year.
    - If the agent determines that the total compensation the person received (or which became no longer subject to a substantial risk of forfeiture) in an examination year was more than the value of the services the person performed for the organization during the prior years, the agent should treat the excess as an excess benefit transaction in the examination year.
    - Even though an organization intended that the deferred compensation paid in an examination year was for services the disqualified person performed for periods before September 14, 1995, the effective date of IRC 4958, the agent should consider the value of those services.

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Compensation – Services Performed in Prior Years, Continued

Example 1 – Facts

EO is tax-exempt under IRC 501(c)(3). Effective January 1, 1996, EO re-employed C as President for a term of five years. C is a disqualified person as to EO. During this period, EO agreed to pay C the following salary and fringe benefits in return for the services C will perform in each respective year:

1996	$ 200,000
1997	250,000
1998	300,000
1999	350,000
2000	400,000
Total	$1,500,000

In addition, effective January 1, 1996, EO and C entered into a deferred compensation arrangement that was a binding written contract. This contract provided that if C completed his five-year term of employment, at the end of the term, EO would pay C deferred compensation of $1 million in a one lump sum payment as additional compensation for the services C would perform for EO from 1996 through 2000.

C performed services for EO from 1996 through 2000. On January 2, 2001, EO paid C deferred compensation of $1 million.

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Compensation – Services Performed in Prior Years, Continued

Example 1 – Analysis

The Service conducted an IRC 4958 examination of C for 2001. In determining whether any of the $1 million C received in 2001 was an excess benefit under IRC 4958, the agent performed the following analysis:

- For each year from 1996 through 2000, the agent determined C's total compensation, which consisted of:
  - The salary and benefits EO paid C for each year ("Actual Compensation"); and
  - The deferred compensation C is deemed to have earned in each year ("Deemed Compensation").
  - In the absence of evidence to the contrary, the agent treated C as having earned the deferred compensation of $1 million equally in each year from 1996 to 2000, i.e., $200,000 per year.
- The agent compared:
  1. The value of the services C provided to EO in each year from 1996 through 2000, with
  2. The sum of the Actual Compensation and the Deemed Compensation from 1996 through 2000 ("Aggregate Compensation").

Example 1 – Table

	Compensation				
Year	Actual	Deemed	Aggregate	Fair Value	"Excess"
1996	$200,000	$200,000	$400,000	$250,000	$150,000
1997	$250,000	$200,000	$450,000	$300,000	$150,000
1998	$300,000	$200,000	$500,000	$350,000	$150,000
1999	$350,000	$200,000	$550,000	$400,000	$150,000
2000	$400,000	$200,000	$600,000	$450,000	$150,000
Total		$1,000,000			$750,000

Compensation – Services Performed in Prior Years, Continued

Example 1 – Conclusions

- In each year, C's Aggregate Compensation exceeded the fair value of the services C performed for EO during that year.
- Therefore, in each year, C received an excess benefit.
- The excess benefits for each year from 1996 to 2000 are combined.
- Since the combined total for the five-year period was an excess benefit of $750,000, C is treated as having received in 2001 an excess benefit under IRC 4958 of $750,000.

Example 1 – Comments

For purposes of correction under Reg. 53.4958-7, the excess benefit transaction occurred on January 2, 2001, when C received this benefit for Federal income tax purposes. Reg. 53.4958-1(e)(1).

Example 2 – Facts

The facts are the same as in Example 1, except that during the five-year term of the contract, EO agreed to pay C the following salary and fringe benefits:

1996	$75,000
1997	80,000
1998	85,000
1999	90,000
2000	95,000

C completed the term of the contract. On January 2, 2001, EO's Board of Directors awarded C a "bonus" of $500,000 in recognition of C's outstanding service and substantial accomplishments during the term of the contract.

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Compensation – Services Performed in Prior Years, Continued

Example 2 – Table

	Compensation				
Year	Actual	Deemed	Aggregate	Fair Value	Underpayment
1996	$75,000	$100,000	$175,000	$250,000	$75,000
1997	$80,000	$100,000	$180,000	$300,000	$120,000
1998	$85,000	$100,000	$185,000	$350,000	$165,000
1999	$90,000	$100,000	$190,000	$400,000	$210,000
2000	$95,000	$100,000	$195,000	$450,000	$255,000
Total		$500,000			$825,000

Example 2 – Conclusions

- In each year, C's Aggregate Compensation was less than the fair value of the services C performed for EO during that year.
- Therefore, C received no excess benefit for each year. Instead, C was underpaid for each year.
- Consequently, none of the $500,000 C received on January 2, 2001 was an excess benefit under IRC 4958.

Rebuttable Presumption

In General

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, if the disqualified person satisfies three conditions:

(1) The compensation arrangement or the terms of the property transfer are approved in advance by an authorized body of the applicable tax-exempt organization composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement or property transfer. Reg. 53.4958-6(a)(1).

(2) The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination. Reg. 53.4958-6(a)(2).

(3) The authorized body adequately documented the basis for its determination concurrently with making that determination. Reg. 53.4958-6(a)(3).

Checklists

To help agents evaluate whether a rebuttable presumption has been established, two checklists, one for compensation and one for property, appear in Appendix 2 and Appendix 3 of the Exempt Organizations CPE text for FY 2002 (pp. 327 – 333).

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Rebuttable Presumption, Continued

Examinations

Agents conducting an IRC 4958 examination should determine whether the rebuttable presumption applies to each excess benefit transaction between the disqualified person and the applicable tax-exempt organization.

- The agent should determine whether the disqualified person has established that each of the specific requirements described in Reg. 53.4958-6 has been satisfied.

- During the examination of the organization, if the Service obtains any factual information from the organization that arose out of a transactional relationship between the organization and the disqualified person, and this information directly affects an issue in the examination of the disqualified person, the Service should disclose this information to the disqualified person. IRC 6103(h)(4)(C).

    - Example: The president of an IRC 501(c)(3) organization and its chief financial officer ("CFO") verbally agree that the organization will provide her with the use of an automobile as additional compensation. The President documents this verbal agreement by preparing a written memorandum that he places in her personnel file. As part of an examination of the organization, the agent obtains a copy of this memorandum. In an IRC 4958 examination of the CFO, if the economic benefits the CFO received from the organization are an issue, the Service should give a copy of this memorandum to the CFO.

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Rebuttable Presumption, Continued

Conflict of Interest

An applicable tax-exempt organization that has adopted a conflicts of interest policy, such as the sample policy discussed in "Tax-Exempt Health Care Organizations, Revised Conflicts of Interest Policy," 1999 EO CPE 45, 48, does not automatically satisfy the conflict of interest requirement of the rebuttable presumption.

- Many conflicts of interest policies, including the sample IRS policy, require the disclosure of actual and potential conflicts of interest. However, Reg. 53.4958-6(c)(1)(iii) requires the complete absence of conflicts of interest by members of the authorized body, not merely the disclosure of such conflicts.
    - The Preamble to the proposed IRC 4958 regulations, 2001-8 I.R.B. 653, 665 (2/20/01), states:

      > The IRS and the Treasury Department believe that the standards contained in the proposed regulations for determining the absence of a conflict of interest are consistent with the legislative history of section 4958, which requires that the governing body (or committee) be composed entirely of individuals who are free of any conflict of interest, and not merely that its members disclose the existence of any conflict of interest.

- To satisfy the conflict of interest requirement of the rebuttable presumption, it must be established that when the authorized body approved a particular compensation arrangement or property transfer, none of the members of authorized body had a conflict of interest with respect to the proposed transaction. Reg. 53.4958-6(a)(1).
    - Mere disclosure of the conflict will not satisfy the conflict of interest requirement.

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Rebuttable Presumption, Continued

Conflict of Interest – Recusal

- The conflict of interest requirement applies on a transaction-by-transaction basis.
- The conflict of interest requirement applies to all voting members of the authorized body, except if the voting member:
  - Meets with other members only to answer questions;
  - Recuses himself or herself from the meeting; and
  - Is not present during debate and voting on the proposed transaction. Reg. 53.4958-6(c)(1)(ii).

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Rebuttable Presumption, Continued

Comparability

In determining whether the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination, the agent should consider the knowledge and expertise of each of the voting members of the authorized body as to the particular proposed transaction under consideration. Reg. 53.4958-6(c)(2)(i).

- Considering this knowledge and expertise, the agent should determine whether the authorized body had information sufficient to determine whether, under the valuation standards in Reg. 53.4958-4(b), the compensation arrangement in its entirety was reasonable, or the property transfer was at fair market value. Reg. 53.4958-6(c)(2)(i).

- In the case of compensation, relevant information includes, but is not limited to:

  - Compensation levels paid by similarly situated organizations, both taxable and non-taxable, for functionally comparable positions;

  - The availability of similar services in the geographic area of the applicable tax-exempt organization;

  - Current compensation surveys compiled by independent firms; and

  - Actual written offers from similar institutions competing for the services of the disqualified person.

Example

See Reg. 53.4958-6(c)(iv), Example 1.

Aggregate Compensation

In determining comparability involving a proposed compensation arrangement, the authorized body should consider the person's aggregate compensation from the applicable tax-exempt organization, not just the proposed compensation by itself.

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Rebuttable Presumption, Continued

Small Organization	The authorized body of organizations with annual gross receipts of $1 million or less is considered as having appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services. Reg. 53.4958-6(c)(2)(ii); Reg. 53.4958-6(c)(2)(iv), Example 5.
Compensation Surveys Compiled by Independent Firms	In considering current compensation surveys compiled by independent firms, the agent should take into account the following factors: • Whether the compensation surveys were performed by reputable firms having knowledge and expertise in the same industry as that of the applicable tax-exempt organization; • Whether the firms were independent with respect to both the applicable tax-exempt organization and the disqualified person; • Whether the compensation surveys covered the periods that are the subject of the IRC 4958 examination; • Whether the organizations included in the compensation surveys were similarly situated; • Whether the positions considered in the surveys were functionally comparable to the position of the disqualified person; and • The number of compensation surveys and the number of different organizations the firms included in their surveys.
Examples	See Reg. 53.4958-6(c)(iv), Examples 1 - 4.

Correction

In General

An excess benefit transaction is corrected by undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the applicable tax-exempt organization involved in the excess benefit transaction in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards. Reg. 53.4958-7(a).

- The correction amount is the sum of the excess benefit and interest on the excess benefit. Reg. 53.4958-7(c).
- Interest is computed for the period from when the excess benefit transaction occurred to the date of correction. Reg. 53.4958-7(c).

Occurrence

An excess benefit transaction occurs when the disqualified person receives the economic benefit for Federal income tax purposes. Reg. 53.4958-1(e)(1).

- When an excess benefit transaction occurred is important for several reasons:
  - Interest is computed from the date the excess benefit transaction occurred to the date of correction.
  - The interest rate equals or exceeds the applicable Federal rate (AFR), compounded annually, for the month in which the transaction occurred.
  - The period from the date the excess benefit transaction occurred to the date of correction is used to determine whether the appropriate AFR is the Federal short-term rate, the Federal mid-term rate, or the Federal long-term rate. See IRC 1274(d)(1)(A).
  - Period of Limitations. The period of limitations that applies to IRC 4958 excise taxes depends on the information return of the applicable tax-exempt organization (Form 990 or Form 990-EZ) for the period during which the excess benefit transaction occurred. IRC 6501(l)(1).

Continued on next page

Correction, Continued

Occurrence, continued

- Correction. If a correction payment includes the return of the property that was the subject of the excess benefit transaction, the amount of correction is the lesser of the fair market value of the property:
    - When the property is returned to the organization, or
    - When the excess benefit transaction occurred. Reg. 53.4958-7(b)(4)(i).

Example

EO, a section 501(c)(3) organization, pays a salary to DP, a disqualified person, on a semi-monthly basis throughout calendar 2002. In addition, throughout the year, EO pays vendors for providing various fringe benefits for DP. If any portion of DP's salary and fringe benefits is an excess benefit under IRC 4958, it is deemed to have occurred on December 31, 2002, the last day of DP's taxable year. Reg. 53.4958-1(e)(1).

- If on February 15, 2003, EO paid DP a bonus relating to DP's performance and accomplishments during 2002, and if any portion of the bonus was an excess benefit under IRC 4958, it occurred on February 15, 2003. Reg. 53.4958-1(e)(1).

Correction – Return of Specific Property

In General

When the excess benefit transaction involved the transfer of property by the applicable tax-exempt organization to the disqualified person, the disqualified person may correct the excess benefit transaction by returning the specific property to the organization, but only if the organization agrees. Reg. 53.4958-7(b)(4)(i).

- The correction amount is equal to the lesser of the fair market value of the property:
  - When it is returned to the organization, or
  - When the excess benefit transaction occurred. Reg. 53.4958-7(b)(4)(i).
- A disqualified person or persons who received an excess benefit from the excess benefit transaction may not participate in the organization's decision whether to accept the return of the specific property. Reg. 53.4958-7(b)(4)(iii).

Family Members of Disqualified Person

Not only may a disqualified person who received an excess benefit from the excess benefit transaction not participate in the organization's decision whether to accept the return of the specific property, but family members of the disqualified person, as defined in Reg. 53.4958-3(b)(1), also may not participate, even though they may not have received an excess benefit from the excess benefit transaction.

- As a result of this restriction, if the organization, under its organizing documents and bylaws, is unable take action as to this matter, the agent should contact Rulings and Agreements, Washington, D.C. for guidance.

Correction – Organization is No Longer Exempt

IRC 501(c)(3) Organization

If the organization that had engaged in the excess benefit transaction no longer exists or is no longer tax-exempt under IRC 501(c)(3), to achieve correction under Reg. 453.4958-7, the disqualified person must pay the correction amount to another organization exempt under IRC 501(c)(3) based on the dissolution clause in the organization's articles or incorporation (or similar document), but only if:

- The recipient organization is a public charity and has been a public charity for a continuous period of at least 60 calendar months ending on the correction date;
- The disqualified person is not also a disqualified person as to the recipient organization; and
- The recipient organization does not allow the disqualified person (or related persons) to make or recommend any grants or distributions by the organization. Reg. 53.4958-7(e)(2).

Dissolution Clause

If the organization or organizations named in the dissolution clause does not satisfy these three requirements, the agent should contact Rulings and Agreements, Washington, D.C. for guidance.

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Correction – Organization is No Longer Exempt, Continued

IRC 501(c)(4) Organization

If the organization that had engaged in the excess benefit transaction no longer exists or is no longer tax-exempt under IRC 501(c)(4), to achieve correction under Reg. 53.4958-7, the disqualified person must pay the correction amount to a successor IRC 501(c)(4) organization.

- If there is no tax-exempt successor, the disqualified person must pay the correction amount to any IRC 501(c)(3) or IRC 501(c)(4) organization, but only:
  - If the recipient organization is an IRC 501(c)(3) organization, it is a public charity and has been a public charity for a continuous period of at least 60 calendar months ending on the correction date;
  - If the recipient organization is an IRC 501(c)(4) organization, it has been in existence for a continuous period of at least 60 calendar months ending on the correction date;
  - The disqualified person is not also a disqualified person as to the recipient organization; and
  - The recipient organization does not allow the disqualified person (or related persons) to make or recommend any grants or distributions by the organization. Reg. 53.4958-7(e)(3).

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Correction – Organization is No Longer Exempt, Continued

Revocation Not In Dispute

If an agent has proposed revocation of an organization's exemption and the organization has agreed to the revocation, the disqualified person does not achieve correction under Reg. 53.4958-7 by making correction payments to the organization.

- In that event, the disqualified person makes correction payments to another organization, as discussed above.
- When the Service revokes an organization's exemption, the Service may grant the organization retroactive relief under IRC 7805(b). In that event:
  - Revocation would be effective prospectively, but
  - The disqualified person does not achieve correction under Reg. 53.4958-7 by making correction payments to the organization.
  - The disqualified person achieves correction under Reg. 53.4958-7 only by making correction payments to another organization, as discussed above.

Revocation in Dispute

If an agent has proposed revocation of an organization's exemption and the organization has not agreed to the revocation, the disqualified person does not achieve correction under Reg. 53.4958-7 by making correction payments to the organization.

- If the revocation issue has been resolved in the organization's favor, the disqualified person may achieve correction under Reg. 53.4958-7 by making correction payments to the organization.
- If the disqualified person wants to make correction before the issue of revocation has been resolved, the agent should contact Rulings and Agreements, Washington, D.C. for guidance.

Correction – Deduction of Excess Compensation Repayments

Correction Amount

When the excess benefit a disqualified person received from an applicable tax-exempt organization consisted of compensation, the correction amount is the excess benefit compensation plus the appropriate interest. Reg. 53.4958-7(c).

Not Deductible as Charitable Contributions

For federal income tax purposes, the disqualified person may not deduct as a charitable contribution under IRC 170 any portion of the correction payment made to an IRC 501(c)(3) organization.

Closing Agreement

If correction payments under Regs. 53.4958-7 are part of a closing agreement, the closing agreement should include a provision expressly prohibiting the disqualified person from deducting as a charitable contribution under IRC 170 any portion of the correction payments made to an IRC 501(c)(3) organization.

Deductible as Compensation

If a disqualified person had included in gross income under IRC 61 compensation from an applicable tax-exempt organization, and a portion of this compensation is subsequently determined to be an excess benefit, if the person corrects the excess benefit transaction under Regs. 53.4958-7 by paying the organization the amount of the excess benefit plus interest:

- For federal income tax purposes, the person may deduct the amount of repaid compensation as a miscellaneous itemized deduction under IRC 67.
    - If IRC 1341 applies to the repaid compensation, the amount repaid would not be subject to the two-percent floor. IRC 67(b)(9).
    - In any event, the repaid compensation is subject to the overall limitation on itemized deductions under IRC 68.
- The amount of interest paid is not deductible for federal income tax purposes.

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Correction – Deduction of Excess Compensation Repayments,
Continued

Closing Agreement

If correction payments under Reg. 53.4958-7 that relate to repaid compensation and interest are part of a closing agreement, the closing agreement may include a provision regarding the deductibility of the repaid compensation and the non-deductibility of interest.

Abatement of 25% Tax

In General

If certain requirements are met, the 25% tax imposed on an excess benefit transaction, including interest, may not be assessed, but if it is assessed, the assessment may be abated, and if the tax is collected, it may be credited or refunded as an overpayment. IRC 4962; IRC 4963; Regs. 53.4963-1.

- For convenience, these acts are collectively referred to as "abatement."
- The requirements for abatement are:
  - Correction of the excess benefit within the correction period;
  - The excess benefit transaction was due to "reasonable cause;" and
  - The excess benefit transaction was due not to "willful neglect."
- In United States v. Boyle, 469 U.S. 241 (1985), the Supreme Court stated that "reasonable cause" and "willful neglect" are two separate standards. 469 U.S. at 245.

"Reasonable Cause"

"Reasonable cause" means exercising "ordinary business care and prudence." Regs. 53.4958-1(d)(6); Regs. 53.4941(a)-1(b)(5); Regs. 301.6651-1(c).

- Determining "reasonable cause" requires a consideration of all the facts and circumstances. Regs. 301.6651-1(c).
- In United States v. Boyle, 469 U.S. 241 (1985), the Supreme Court held that the term "reasonable cause" means "ordinary business care and prudence." 469 U.S. at 246.

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Abatement of 25% Tax, Continued

"Willful Neglect"

"Not willful neglect" means that the receipt of the excess benefit was not due to the disqualified person's conscious, intentional or voluntary failure to comply with IRC 4958, and that the noncompliance was not due to conscious indifference. Regs. 53.4958-1(d)(5); Regs. 53.4941(a)-1(b)(4).

- An act is "willful" if it is "voluntary, conscious, and intentional." Regs. 53.4958-1(d)(5); Regs. 53.4941(a)-1(b)(4).
- "Negligence" includes any failure to make a reasonable attempt to comply with the law. IRC 6662(c).
- "Willful neglect" implies failure to exercise the care a reasonable person would observe under the circumstances to see that the standards were observed, despite knowledge of the standards or rules in question.
- In United States v. Boyle, 469 U.S. 241 (1985), the Supreme Court stated that the term "willful neglect" means "a conscious, intentional failure or reckless indifference." 469 U.S. at 245.

Safe Harbor Guidelines

In an effort to encourage IRC 501(c)(3) and IRC 501(c)(4) organizations and disqualified persons to identify excess benefit transactions and to promptly correct them, the Service has adopted two safe harbor guidelines.

- These safe harbor guidelines will apply only if the disqualified person discovers or acquires actual or constructive knowledge of the excess benefit transaction before the organization received an examination notice from the IRS regarding any of its Forms 990 and before the disqualified person received an examination notice from the IRS regarding an IRC 4958 examination.

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Abatement of 25% Tax, Continued

30-Day Safe Harbor	If a disqualified person completes correction of an excess benefit transaction under Regs. 53.4958-7(a) within 30 days after the disqualified person discovers, or acquires actual or constructive knowledge, that the transaction was an excess benefit transaction, the IRS will treat the disqualified person as having satisfied the requirements for reasonable cause and not willful neglect under IRC 4962(a)(1). See Regs. 301.6724-1(d)(1)(ii)(D).
More-Than-30-Day Safe Harbor	If a disqualified person completes correction of an excess benefit transaction under Regs. 53.4958-7(a) more than 30 days after the disqualified person discovers, or acquires actual or constructive knowledge, that the transaction was an excess benefit transaction, the IRS will consider all the relevant facts and circumstances relating to the process of correction to determine whether to treat the disqualified person as having satisfied the requirements for reasonable cause and not willful neglect under IRC 4962(a)(1).
Area Office	In determining whether the safe harbor guidelines apply to a disqualified person as to a specific excess benefit transaction, the Area Office having jurisdiction over the disqualified person should consider all the facts and circumstances.

Period of Limitations

In General

The period of limitations that applies to IRC 4958 excise taxes depends on the information return (Form 990 or Form 990-EZ) of the applicable tax-exempt organization for the period during which the excess benefit transaction occurred.

Period of Limitations Begins

The period of limitations begins on the later of:

- The due date of the organization's information return, or
- The date the organization filed its information return.

IRC 6501(b)(1); IRC 6501(b)(4); IRC 6501(l)(1); Reg. 301.6501(n)-1(a)(1); Reg. 301.6501(n)-1(c).

Period of Limitations Ends in 3 Years

The period of limitations generally ends three years after it begins. IRC 6501(a); Reg. 301.6501(a)-1(a).

Period of Limitations Ends in 6 Years

If the organization, on its Form 990 for the period during which the excess benefit transaction occurred, did not adequately disclose the excess benefit transaction in a manner sufficient to apprise the Service of the existence and nature of the excess benefit transaction with the disqualified person, the period of limitations ends six years after it begins. IRC 6501(e)(3); Reg. 301.6501(e)-1(c)(3)(ii); Rev. Rul. 69-247, 1969-1 C.B. 303.

- The Service has the burden of proving that the disclosure of information on its Form 990, or in a schedule or statement attached to the return, was insufficient to apprise the Service of the existence and nature of the excess benefit transaction with the disqualified person.

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Period of Limitations, Continued

Form 872

If necessary, agents should obtain an executed Form 872 (Consent to Extend the Period of Assessment) from each disqualified person.

- Although the period of limitations under IRC 4958 depends on the information return of the applicable tax-exempt organization, agents should prepare Form 872 using the taxable year of the disqualified person.
- Agents should prepare separate Forms 872 for each disqualified person.
    - For example, if a husband and wife are each disqualified persons, the agent should prepare a separate Form 872 for each spouse. A "joint" Form 872 is not permitted.

Revocation of Exemption

Substantive Requirements for Exemption Still Apply

IRC 4958 does not affect the substantive standards for tax exemption of an applicable tax-exempt organization under IRC 501(c)(3) or IRC 501(c)(4). This includes the requirements that the organization be organized and operated exclusively for exempt purposes, and that no part of its net earnings inure to the benefit of any private shareholder or individual.

- Thus, regardless of whether a particular transaction is subject to excise taxes under IRC 4958, existing principles and rules continue to apply, such as the limitation on private benefit. Reg. 53.4958-8(a).

- If an agent who is conducting an examination of an organization that is tax-exempt under IRC 501(c)(3) or IRC 501(c)(4) identifies issues involving potential private benefit or inurement, the agent should consider opening an IRC 4958 examination of the persons or persons involved in the potential private benefit or inurement transactions.

Penalties - IRC 6684

In General

The 25% and the 200% excise taxes under IRC 4958 are payable by the disqualified person who received the excess benefit from an excess benefit transaction with the applicable tax-exempt organization. Reg. 53.4958-1(c). The 10% excise tax is payable by the organization manager who knowingly participated in the excess benefit transaction. Reg. 53.4958-1(d)(1).

Penalties

In addition to being liable for the payment of excise taxes under IRC 4958, a disqualified person and an organization manager may be liable for the payment of penalties. IRC 6684.

100% Penalty

A disqualified person or an organization manager who is liable for the payment of an excise tax under IRC 4958 because of an act or failure to act which is not due to reasonable cause is subject to a penalty of 100% of the excise tax under IRC 4958 if:

- The disqualified person or organization manager had previously been liable for any tax under IRC 4958; or
- Such act or failure to act is both willful and flagrant.

Facts and Circumstances

In determining whether the 100% penalty should apply, agents should consider all the relevant facts and circumstances.

Continued on next page

Penalties - IRC 6684, Continued

Burden of Proof

- The disqualified person or the organization manager has the burden of proving that the act or failure to act was due to reasonable cause. An affirmative showing of reasonable cause must be made in the form of a written statement, containing a declaration by the person that it is made under the penalties of perjury, setting forth all the facts alleged as reasonable cause. Reg. 301.6684-1(b).

- The Service has the burden of proving that the act or failure to act was both willful and flagrant.

  - The term "willful and flagrant" has the same meaning as it has in IRC 507(a)(2)(A) and the applicable regulations. Reg. 301.6684-1(c).

  - Reg. 1.507-1(c)(2) states:

    ... [A] "willful and flagrant act (or failure to act)" is one which is voluntarily, consciously and knowingly committed in violation of any provision of chapter 42 . . . and which appears to a reasonable man to be a gross violation of any such provision.

  - Reg. 1.507-1(c)(5) states:

    No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make an act (or failure to act) willful. However, a foundation's act (or failure to act) is not willful if the foundation (or a foundation manager, if applicable) does not know that it is an act of self-dealing, a taxable expenditure, or other act (or failure to act) to which chapter 42 applies.