H. AN INTRODUCTION TO I.R.C. 4958 (INTERMEDIATE SANCTIONS)

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Introduction

On January 10, 2001, the Treasury Department issued temporary regulations under I.R.C. 4958, which imposes excess taxes on excess benefit transactions involving organizations exempt under I.R.C. 501(c)(3) and 501(c)(4). These regulations are important to the exempt organization community and to the Exempt Organization Division of the Tax Exempt and Government Entities (TE/GE) Division, which has the responsibility for ensuring compliance with I.R.C. 4958. The temporary regulations will be effective until January 9, 2004.

This article reviews these temporary regulations to assist examiners in examining excess benefit transactions. It should be read with the temporary regulations, including the regulations' many helpful examples. The appendices provide additional tools. In addition, EO Technical personnel are ready to assist examiners at any step in an examination.

Appendix 1 (I.R.C. 4958 in Steps) is a checklist to help examiners identify and analyze excess benefit transactions. *Appendix 2* (Rebuttable Presumption Checklist - Compensation), and *Appendix 3* (Rebuttable Presumption Checklist - Property) are guides to satisfying the requirements for establishing the rebuttable presumption under Regs. 53.4958-6T.

This article is divided into five sections:

Section A – Definitions
1. Applicable Tax-Exempt Organization
2. Disqualified Person
3. Organization Manager

Section B – Excess Benefit Transactions, Etc.
1. Excess Benefit Transactions
2. Revenue Sharing
3. Rebuttable Presumption

Section C – Imposition of Taxes and Correction
1. Effective Date
2. Occurrence
3. 25% Tax
4. 200% Tax

5. 10% Tax
6. Correction
7. Abatement
8. Period of Limitations
9. Notice of Deficiency
10. Penalties

Section D – Administrative Matters

1. Revocation
2. Churches
3. Technical Advice

Section E – Fringe Benefits

1. Fringe Benefits Taxation Generally
2. Overview of I.R.C. 4958 and Fringe Benefits
3. In-Depth Discussion of I.R.C. 132
4. Fringe Benefits Subject to Other Statutory Exclusions
5. Treatment of Fringe Benefits Not Excludable from Income
6. Valuation of Fringe Benefits
7. Employment Tax Treatment of Fringe Benefits

Section F – Conclusion

Discussion

A. Definitions

1. Applicable Tax Exempt Organization. Regs. 53.4958-2T.

I.R.C. 4958 imposes excise taxes on *excess benefit transactions* between *disqualified persons* and tax-exempt organizations described in either I.R.C. 501(c)(3) or I.R.C. 501(c)(4). These organizations are referred to as "applicable tax exempt organizations." This article will usually refer to an "applicable tax-exempt organization" simply as an *organization*.

An *organization* includes an entity that was tax-exempt under I.R.C. 501(c)(3) or I.R.C. 501(c)(4) any time in the five-year period before the *excess benefit transaction occurred*. This rule is called the "Lookback Rule," and the five-year period is the "Lookback Period." But if the *excess benefit transaction occurred* before September 14, 2000, the Lookback Period begins on September 14, 1995, the effective date of I.R.C. 4958, and ends on the date the *excess benefit transaction occurred*.

However, the following are not *organizations*:

i. A private foundation.

ii. A governmental entity that is not subject to taxation.

iii. A foreign organization tax-exempt under I.R.C. 501(c)(3) or I.R.C. 501(c)(4) that receives substantially all of its support from sources outside the U.S.

iv. An I.R.C. 501(c)(3) or I.R.C. 501(c)(4) entity whose exemption was never recognized or was revoked. However, if revocation was based on the presence of private inurement or impermissible private benefit, the entity would be an *organization* during the revocation period. Also, an entity whose exemption was revoked could be an *organization* based on the Lookback Rule.

2. Disqualified Person. Regs. 53.4958-3T.

A *disqualified person* is any person in a position to exercise *substantial influence* over the affairs of the *organization* at any time in the Lookback Period. To be a *disqualified person*, it is not necessary that the person actually exercise *substantial influence*, only that the person be in a position to exercise *substantial influence*.

Family members of the *disqualified person* and entities controlled by the *disqualified person* are also *disqualified persons*. For this purpose, control is defined as owning more than 35% voting power.

i. Substantial Influence. Regs. 53.4958-3T(c). Persons who hold any of the following powers, responsibilities, or interests are considered to be in a position to exercise *substantial influence* over the affairs of the *organization*.

a. A voting member of the governing body.

b. Regardless of title, a person who has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration or operation of the *organization* (such as president, chief executive officer or chief operating officer).

c. Regardless of title, a person who has ultimate responsibility for managing the finances of the *organization* (such as the treasurer or chief financial officer).

If ultimate responsibility resides with two or more individuals who may exercise this responsibility together or individually, then each individual is in a position to exercise *substantial influence*.

ii. No Substantial Influence. Regs. 53.4958-3T(d). Certain persons are considered as not being in a position to exercise *substantial influence* over the affairs of the *organization*, such as:

a. I.R.C. 501(c)(3) and I.R.C. 501(c)(4) organizations.

b. Employees of the *organization* who receive economic benefits in a taxable year of less than a specified amount. (For 2001, this amount is $85,000, but is subject to change each year.). But these employees must not be:

(1) Family members of *disqualified person;*
(2) Persons who are considered to be in a position to exercise *substantial influence* over the affairs of the *organization*; or
(3) Substantial contributors to the *organization*.

iii. Facts and Circumstances. Any other person may or may not be *disqualified person,* depending on the facts and circumstances.

a. The following are examples of facts and circumstances tending to show that a person has *substantial influence* over the affairs of the *organization*. Regs. 53.4958-3T(e)(2).

(1) The person founded the *organization.*
(2) The person is a substantial contributor to the *organization.*
(3) The person's compensation is based primarily on revenues derived from *organization* activities the person controls.
(4) The person has or shares authority to control or determine a substantial portion of the *organization's* capital expenditures, operating budget or compensation for employees.
(5) The person manages a discrete segment or activity of the *organization* that represents a substantial portion of its activities, assets, income or expenses.
(6) The person owns a controlling interest (measured by either vote or value) in a corporation, partnership or trust that is a *disqualified person.*

(7) The person is a non-stock organization controlled directly or indirectly by one or more *disqualified persons*.

b. The following are examples of facts and circumstances tending to show that a person does not have *substantial influence* over the affairs of the *organization.* Regs. 53.4958-4T(e)(3).

(1) The person has taken a *bona fide* vow of poverty as an employee, agent, or on behalf, of a religious organization.
(2) The person is an independent contractor whose sole relationship to the *organization* is providing professional advice and the person:
    (i) Has no decision making authority, and
    (ii) Will derive no direct or indirect benefit from the transaction except for customary fees for professional advice.
(3) The direct supervisor of the person is not a *disqualified person.*
(4) The person does not participate in any management decisions affecting the *organization* as a whole or affecting a discrete segment of the *organization* that represents a substantial portion of its activities, assets, income or expenses of the *organization*, as compared to the *organization* as a whole.
(5) Any preferential treatment a person receives based on the size of the person's donation is:
    (i) Also offered to all other donors making comparable contributions, and
    (ii) Offered as part of a solicitation intended to attract a substantial number of contributions.

Where there are affiliated *organizations*, the determination of whether a person has *substantial influence* is made separately for each *organization*. A person may be a *disqualified person* regarding transactions with more than one *organization*.

3. Organization Manager. Regs. 53.4958-1T(d)(2).

An *organization manager* is an officer, director, or trustee of an *organization*, or any individual having powers or responsibilities similar to officers, directors or trustees, regardless of the individual's title.

A person is an officer of an *organization* if that person is specifically designated as such in the *organization's* certificate of incorporation, bylaws, or other organizational documents, or who regularly exercises authority to make administrative or policy decisions for the *organization*.

An independent contractor who acts solely in a capacity as an attorney, accountant, or investment manager or advisor is not an officer of an *organization.* Nor is a person

who has authority to merely recommend particular administrative or policy decisions, but not to implement them.

However, if a person who is not an officer, director, or trustee of an *organization* is a member of a committee of the *governing body* of the *organization*, and the committee is attempting to invoke the *rebuttable presumption* under Regs. 53.4958-6T, based on the committee's actions, this person is considered as an *organization manager*.

B. Excess Benefit Transactions, Etc.

1. Excess Benefit Transactions. Regs. 53.4958-4T.

An *excess benefit transaction* is a transaction in which:

- An economic benefit is provided by an *organization*, directly or indirectly, to or for the use of a *disqualified person*, and

- The value of the economic benefit provided by the *organization* exceeds the value of the consideration received by the *organization* in return for providing the benefit.

To determine if an *excess benefit transaction occurred*, include all consideration and benefits exchanged between or among the *disqualified person*, the *organization*, and all entities it controls.

A transaction that is accomplished indirectly, such as through the use of a controlled entity or through an intermediary, is an *excess benefit transaction* if the transaction would have been an *excess benefit transaction* had the *organization* engaged in it directly with the *disqualified person*. "Control" occurs if the *organization* has 50 percent or more control over the other entity.

Any economic benefit received by a *disqualified person* from the assets of an *organization* is considered to be provided by the *organization* even if the transfer was not authorized under the *organization's* regular procedures. So, amounts embezzled by a *disqualified person* from an *organization* are considered an *excess benefit transaction*.

i. Fixed Benefits under an Initial Contract. Regs. 53.4958-4T(a)(3).

Initial Contract Exception. I.R.C. 4958 does not apply to *fixed payments* made by an *organization* to a *disqualified person* pursuant to an *initial contract.* This exception (also referred to as the "First Bite Rule") applies only to the fixed, not the variable, component of an *initial contract*.

a. Initial Contract. An *initial contract* is a *binding written contract* between an *organization* and a person who was not a *disqualified person* immediately before entering into the contract.

(1) An *initial contract* is treated as a new contract and is no longer subject to the First Bite Rule when:

(i) The contract provides that it may be terminated or cancelled by the *organization* (except for substantial non-performance) without the *disqualified person's* consent, and

(ii) Without substantial penalty to the *organization*.

(2) The new contract is treated as a new contract as of the earliest date any termination or cancellation would be effective.

(3) If the *organization* and the *disqualified person* make a *material change* to an *initial contract*, it is treated as a new contract as of the date the *material change* is effective.

(i) A *material change* includes an extension or renewal of the contract (except for an extension or renewal resulting from the exercise of an option) or a more than incidental change to the amount payable under the contract.

(ii) Any new contract is tested under the above definition to determine whether it is an *initial contract*.

b. Fixed Payment. 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, that is paid or transferred in exchange for the provision of specified services or property.

(1) A *fixed payment* does not include any amount paid to a person under a reimbursement or similar arrangement where any person has discretion regarding the amounts incurred or reimbursed.

(2) A *fixed formula* may incorporate an amount that depends upon future *specified events or contingencies*, but no one can have discretion when calculating the amount of a payment or deciding whether to make a payment (such as a bonus). A *specified event or contingency* may include the amount of revenues generated by

(or other objective measure of) one or more activities of the *organization*.

c. The Initial Contract Exception does not apply to *fixed payments* made in a year unless the *disqualified person* substantially performs his or her obligations in that year under the contract.

ii. Disregarded Benefits. Regs. 53.4958-4T(a)(4).

Certain economic benefits are disregarded for purposes of I.R.C. 4958, such as:

a. In-kind fringe benefits excluded from gross income under I.R.C. 132 (except certain liability insurance premiums, payments or reimbursements).

b. Certain benefits provided to volunteers, members or donors.

c. Benefits provided to a charitable beneficiary.

d. Benefits provided to or for the use of a governmental unit for exclusively public purposes.

Even though not listed in the Temporary Regulations, to provide consistent treatment of benefits provided in cash and in kind, pending final I.R.C. 4958 regulations, expense reimbursements paid under an "accountable plan" under Regs. 1.62-2(c)(2) may be disregarded.

iii. Valuation. Regs. 53.4958-4T(b)(1)(i).

In an *excess benefit transaction*, the general rule for the valuation of property, including the right to use property, is *fair market value*.

Fair market value is the price property, or the right to use property, would change hands between a willing buyer and a willing seller. Neither party can be under any compulsion to buy, sell, or transfer property or the right to use property. Both parties must have a reasonable knowledge of the relevant facts.

iv. Compensation. Regs. 53.4958-4T(b)(1)(ii).

The *fair market value* of economic benefits received for the performance of services is *reasonable compensation*.

a. *Reasonable compensation* is the value of services that would ordinarily be paid for like services by a like enterprise under like circumstances. The rules under I.R.C. 162 apply in determining if the compensation a *disqualified person* received was reasonable.

   The fact that a bonus or revenue-sharing arrangement is subject to a cap is a relevant factor in determining if the compensation is *reasonable*.

   State or local legislature or court approval of a particular compensation package would be a factor, though not in itself conclusive, in determining if compensation was *reasonable*.

   Except for fringe benefits excludable from gross income under I.R.C. 132, compensation includes all economic benefits (including taxable fringe benefits) provided by an *organization* to or for the *disqualified person* in exchange for the performance of services, regardless of how they are treated for federal income tax purposes.

b. Examples of economic benefits included in determining if compensation is *reasonable* are:

   (1) All forms of cash and non-cash compensation, including salary, fees, bonuses, severance payments and deferred and non-cash compensation.

   (2) The payment of liability insurance premiums, or the payment or reimbursement by the *organization*, for the following items (unless excludable from gross income as a *de minimis* fringe benefit under I.R.C. 132(a)(4)):

      (i) Any penalty, tax or expense of correction owed under I.R.C. 4958.

      (ii) Any expense not reasonably incurred in a civil proceeding arising out the performance of services for the organization.

      (iii) Any expense resulting from an act, or failure to act, where the person has acted *willfully* and without *reasonable cause*.

   (3) All other compensatory benefits, whether or not included in gross income for income tax purposes.

(4) Taxable and nontaxable fringe benefits. (See Section E.)

(i) Fringe benefits excludable from gross income under I.R.C. 132 are disregarded.

(ii) Expense reimbursements paid under an "accountable plan" under Regs. 1.62-2(c)(2) may also be disregarded, pending final regulations.

(5) Certain expense allowances or reimbursements paid under a "nonaccountable plan" under Regs. 1.62-2(c)(3).

(6) Foregone interest on loans.

c. Fixed Payment. Determining the *reasonableness* of a *fixed payment* under a contract considers the facts and circumstances that existed when the organization and the *disqualified person* entered the contract.

d. Non-Fixed Payment. Determining the *reasonableness* of a non-fixed payment considers all facts and circumstances up to and including those occurring on the date of payment. However, it does not consider circumstances existing when the Service questions the payment.

e. Prior Years. In some circumstances, determining the *reasonableness* of compensation for one year may take into account services performed by the *disqualified person* in prior years.

f. Intent to Treat as Compensation. Regs. 53.4958-4T(c).

(1) An economic benefit provided to a *disqualified person* that is treated as compensation is considered together with other compensatory benefits to determine if the total compensation provided by the *organization* is reasonable.

(2) An economic benefit provided to a *disqualified person* that is <u>not</u> treated as compensation is considered as an *excess benefit transaction*, unless the *disqualified person* can establish that it was properly excludable from income for income tax purposes, or it involved a legitimate non-compensatory transaction with the *organization*.

(3) An economic benefit provided to a *disqualified person* is not treated as compensation unless the *organization* clearly

demonstrates its *intent* to treat the benefit as compensation when the benefit was transferred. *Intent* is demonstrated by written *substantiation* that is *contemporaneous* with the transfer of the economic benefit.

(i) *Contemporaneous* s*ubstantiation* can be demonstrated by:

(a) The *organization* reporting the benefit as compensation on an original or amended Form W-2, 1099 or 990. But the amended form must be filed before the Service has started an audit of the *organization* or the *disqualified person*; or

(b) The *disqualified person* reporting the benefit as income on an original or amended Form 1040. But the amended Form 1040 must be filed before the Service has started an audit of the *organization* or the *disqualified person*; or

(c) Other written *contemporaneous* evidence demonstrating that the *authorized body* or an officer authorized to approve compensation has approved a transfer as compensation in accordance with established procedures. For example:

(I) An approved written employment contract executed on or before the date of transfer.

(II) Documentation satisfying the documentation requirements for the *rebuttable presumption* indicating that an authorized body approved the transfer as compensation for services on or before the date of transfer.

(d) In the case of fringe benefits that are claimed to be excludable from income, any written evidence that the benefits were intended as compensation is sufficient substantiation (for example: a contract; board minutes; an employee handbook; or an opinion by a benefits company, an attorney, a C.P.A., or an enrolled agent that the benefit is excludable from income.)

(ii) If the *organization* did not report the benefit as required, but the failure to report was due to *reasonable cause*, the requirement of *intent* would be satisfied. *Reasonable cause* (*see* I.R.C. 301.6724-1 of the regulations) can be established if:

(a) There were significant mitigating factors with respect to the failure to report, or

(b) The failure to report arose from events beyond the organization's control.

Also, the filer of the form must establish that the filer acted in a responsible manner both before and after the failure occurred.

2. Revenue Sharing. Regs. 53.4958-5T.

Certain revenue sharing transactions between a *disqualified person* and an *organization* can result in *excess benefit transactions*. This occurs when an economic benefit provided to or for the use of a *disqualified person* is determined in whole or in part by the revenues of one or more activities of the *organization*, but only if the transaction results in inurement under I.R.C. 501(c)(3) or I.R.C. 501(c)(4).

The temporary regulations do not discuss this kind of *excess benefit transaction*. Until final regulations on revenue sharing transactions are issued, it will be evaluated under the same principles that apply to all *excess benefit transactions* between a *disqualified person* and an *organization*, regardless whether the *disqualified person's* compensation is computed by reference to revenues of the *organization*.

3. Rebuttable Presumption. Regs. 53.4958-6T.

If an *organization* meets the following three requirements, payments it makes to a *disqualified person* 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*. Failure to meet the three requirements does not, however, automatically mean the transaction is an *excess benefit transaction*.

The three requirements for establishing the *rebuttable presumption* are:

i. Approval in Advance by an Authorized Body. Regs. 53.4958-6T(a)(1).

The compensation arrangement, or the terms of the property transfer, must be approved in advance by an *authorized body* of the *organization* or by an entity it controls. The *authorized body* must be composed entirely of individuals who do not have a *conflict of interest* for the compensation arrangement or the property transfer.

a. Authorized Body. Regs. 53.4958-6T(c)(1).

Usually, an *authorized body* is the organization's governing body, such as its board of directors, board of trustees, or an executive committee.

If permitted by state law, an *authorized body* may also be others who are authorized by the governing body to act on its behalf. This body must follow procedures specified by the governing body in approving compensation arrangements or property transfers.

When an *authorized body* is reviewing a transaction, an individual is not included on the *authorized body* if that individual meets only to answer questions and otherwise recuses himself from the meeting.

b. Conflict of Interest. Regs. 53.4958-6T(c)(1)(iii).

A member of an *authorized body* does not have a *conflict of interest* for a compensation arrangement or property transfer if the member meets <u>all</u> these requirements:

(1) The member is neither the *disqualified person* who participated in or economically benefited from the transaction, nor is a member of the *disqualified person's* family.

(2) The member is not in an employment relationship that is subject to the direction or control of any *disqualified person* participating in or economically benefiting from the transaction.

(3) The member does not receive compensation or other payments subject to approval by any *disqualified person* participating in or economically benefiting from the transaction.

(4) The member has no financial interest affected by the transaction.

(5) The member does not approve a transaction providing benefits to a *disqualified person* participating in the transaction under consideration, who in turn approved or will approve another transaction providing benefits to the member.

ii. Reliance on Comparable Data. Regs. 53.4958-6T(c)(2).

The *authorized body* obtained and relied on appropriate data for comparability before making its determination.

An *authorized body* has appropriate data for comparability if, considering the knowledge and expertise of its members, it has information sufficient to determine if the compensation is *reasonable* or the property transfer is at *fair market value*.

a. Compensation. If compensation, relevant information includes:

(1) Compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions.

(2) The availability of similar services in the geographic area.

(3) Current compensation surveys compiled by independent firms.

(4) Actual written offers from similar institutions competing for the services of the *disqualified person.*

b. Property Transfers. If property transfers, examples of relevant information are:

(1) Current independent appraisals of the value of the property that will be the subject of the property transfer with the *disqualified person*.

(2) Offers received as part of an open and competing bidding process.

c. Small Organizations. For certain small *organizations* reviewing compensation arrangements, the *authorized body* is considered to have appropriate data for comparability if it has data on compensation paid by three comparable organizations in the same or similar communities.

A small *organization* is one having gross receipts of less than $1 million per year. A small *organization* may calculate its annual gross receipts based on its average gross receipts in the three prior taxable years. But if a small *organization* is controlled by or controls another entity, the annual gross receipts of all *organizations* must be aggregated.

iii. Documentation. Regs. 53.4958-6T(c)(3).

The *authorized body adequately documented* the basis for its determination *concurrently* with making that determination.

a. Adequately Documented. For a determination by an *authorized body* to be *adequately documented*, the records must note all the following items:

(1) The terms of the transaction approved and the date approved.

(2) The members of the *authorized body* present during debate and those who voted.

(3) The comparability data relied on and how it was obtained.

(4) Any actions taken by a member of the *authorized body* who had a *conflict of interest* for the transaction.

(5) If the *authorized body* determined that the reasonable compensation or that the *fair market value* varied from the range of comparable data obtained, the basis for this determination.

b. Concurrently. For a determination by an *authorized body* to be *adequately documented concurrently*, records must be prepared by the next meeting or 60 days after final action by the *authorized body* is taken, whichever occurs later. Within a reasonable time thereafter, the records must be reviewed and approved by the *authorized body* as reasonable, accurate and complete.

iv. Fixed Payments. For *fixed payments*, the *rebuttable presumption* applies to all payments made or transactions completed under a contract as long as the above three requirements were met when the *disqualified person* and the *organization* entered into the contract.

v. Non-Fixed Payments.

a. For *non-fixed payments*, a *rebuttable presumption* cannot arise until:

(1) The exact amount of the payment is determined, or a fixed formula for calculating the payment is specified; and

(2) The three *rebuttable presumption* requirements above are met.

b. However, if the *authorized body* approves an employment contract with a *disqualified person* that includes a *non-fixed payment* (such as a discretionary bonus) up to a specified cap, the *rebuttable presumption* would be established if:

(1) Before approving the contract, the *authorized body* obtains appropriate comparability data indicating that a fixed payment of up to a certain amount to the *disqualified person* would represent *reasonable* compensation;

(2) The maximum amount payable under the contract, taking into account both fixed and *non-fixed payments*, does not exceed this amount; and

(3) The three *rebuttable presumption* requirements above are met.

vi. Rebutting the Presumption. Regs. 53.4958-6T(b).

a. The *rebuttable presumption* may be rebutted if the Service develops sufficient contrary evidence to rebut the probative value of the comparability data relied on by the *authorized body*.

b. For a *fixed payment*, rebuttal evidence is limited to evidence relating to facts and circumstances existing when the *disqualified person* and the *organization* entered the contract under which the payment is made. For all other payments, rebuttal evidence may include facts and circumstances up to and including the date of payment.

vii. Checklists. Appendix 2 and Appendix 3, Rebuttable Presumption Checklists, are guides for establishing the *rebuttable presumption*. These checklists are for organizations' convenience only and are not required to establish the *rebuttable presumption*.

C. Imposition of Taxes and Correction

1. Effective Date. Regs. 53.4958-1T(f).

I.R.C. 4958 applies to all *excess benefit transactions occurring* on or after September 14, 1995. But I.R.C. 4958 does not apply to *excess benefit transactions* that *occurred* under a written contract binding on September 13, 1995 and at all times thereafter before the *excess benefit transactions occurred*. (This rule is often referred to as the "Binding Contract Exception.")

However, if after September 13, 1995, the binding written contract is *materially changed*, it is treated as a new contract that was entered into as of the effective date of the *material change*. In that event, *excess benefit transactions* that *occurred* under this new contract would be subject to I.R.C. 4958.

A *material change* includes an extension or renewal of the contract or a more than incidental change to any payment under the contract. But it does not include any extension or renewal that results from the person contracting with the *organization* or unilaterally exercising an option expressly granted by the contract.

2. Occurrence. Regs. 53.4958-1T(e).

Besides determining whether the Binding Contract Exception applies to an *excess benefit transaction*, when an *excess benefit transaction* occurred is important for several reasons:

i. The Five-Year Lookback Period for determining if an organization is an *applicable tax-exempt organization* and if a person is a *disqualified person* begins when the *excess benefit transaction* occurred.

ii. Correction. (See Section C.6. below.)

The *correction period* and the *taxable period* each begins when the *excess benefit transaction* occurred.

a. When *correction* involves the return of property, the deemed cash payment made by the *disqualified person* is based on the fair market value of the property when the *excess benefit transaction* occurred, or when the property is returned, whichever is lesser.

b. Interest on the excess benefit begins to accrue when the *excess benefit transaction* occurred.

c. The applicable Federal rate (AFR) used in calculating interest on the excess benefit is the AFR for the month when the *excess benefit transaction occurred*.

d. The period from when the *excess benefit transaction occurred* to the *correction date* is used to determine the appropriate term of the AFR.

The general rule is an *excess benefit transaction occurred* when the *disqualified person* received the economic benefit from the *organization* for federal income tax purposes.

Compensation. When a contract provides for a series of compensation or other payments to a *disqualified person* in the *disqualified person's* taxable year, any *excess benefit transactions* for these payments *occurred* on the last day of the *disqualified person's* taxable year. But if the payments continue for only part of the taxable year, any *excess benefit transaction occurred* on the last payment date in the series.

Benefits provided under a qualified pension, profit-sharing, or stock bonus plan *occurred* on the date the benefit was vested.

When an *organization* transferred property to a *disqualified person* that was subject to a substantial risk of forfeiture, or transferred to a *disqualified person* rights to future compensation or property, (such as benefits under a nonqualified deferred compensation plan), the *excess benefit transaction occurred* when the property, or the rights to future compensation or property, was no longer subject to a substantial risk of forfeiture. However, if the *disqualified person* elected under I.R.C. 83 to include an amount in gross income in the taxable year of transfer, the *excess benefit transaction occurred* when the *disqualified person* received the economic benefit from the *organization* for Federal income tax purposes.

An *excess benefit transaction* involving benefits under a deferred compensation plan that vested in any taxable year of the *disqualified person occurred* on the last day of the *disqualified person's* taxable year.

3. 25% Tax. Regs. 53.4958-1T(c)(1).

I.R.C. 4958 creates a two-tier excise tax structure on *excess benefit transactions*. The "First-Tier Tax" or "Initial Tax" is 25% of the excess benefit resulting from each *excess benefit transaction* between an *organization* and a *disqualified person*.

The 25% tax is payable by the *disqualified person* who received the excess benefit from the *excess benefit transaction*. If more than one *disqualified person* is liable for the 25% tax, all are *jointly and severally* liable for the tax.

Joint and several liability means that all or a portion of the 25% tax may be assessed against and collected from one or more of the *disqualified persons* who received an excess benefit from the *excess benefit transaction*. However, the total tax collected would not exceed 100% of the 25% tax. Under certain circumstances, the 25% tax may be abated.

4. 200% Tax. Regs. 53.4958-1T(c)(2).

If the 25% tax is imposed on an *excess benefit transaction* and the *disqualified person* does not *correct* the excess benefit within the *taxable period*, the 200% tax would be imposed on the *excess benefit transaction*. The "Second-Tier Tax" or "Additional Tax" is 200% of the excess benefit resulting from each *excess benefit transaction* between an *organization* and the *disqualified person*.

So, a *disqualified person* liable for the 25% tax may avoid the 200% tax by properly *correcting* all the excess benefit (and interest) within the *taxable period*. But if a *disqualified person* does not *correct* all the excess benefit (and interest), the 200% would be imposed only on the uncorrected portion of the excess benefit.

The 200% tax is payable by the *disqualified person* who received the excess benefit from the *excess benefit transaction*. If more than one *disqualified person* is liable for the 200% tax, all the *disqualified persons* are *jointly and* severally liable for the tax. However, the total tax collected would not exceed 100% of the 200% tax. Under certain circumstances, the 200% tax may be abated.

5. 10% Tax. Regs. 53.4958-1T(d).

I.R.C. 4958 imposes a tax of 10% of the excess benefit on the *participation* of an *organization manager* in an *excess benefit transaction* between an *organization* and a *disqualified person*. The 10% tax applies if:

i. The 25 percent tax has been imposed on the *disqualified person*;

ii. The *organization manager knowingly participated* in the *excess benefit transaction*, and

iii. The *organization manager's participation* was *willful* and not due to *reasonable cause*.

The Service has the burden of proof in establishing that an *organization manager participated knowingly* and the *organization manager's participation* was *willful* and was not due to *reasonable cause*.

The 10% is payable by the *organization manager* who *participated* in the *excess benefit transaction*. The maximum aggregate amount of 10% tax that may be imposed on an *organization manager* for each *excess benefit transaction* is $10,000. So, if more than one *organization manager knowingly participated* in an *excess benefit transaction*, $10,000 is the maximum amount of 10% tax that may be collected from all the *organization managers* collectively, for their *participation* in that particular *excess benefit transaction*. If more than one *organization manager* is liable for the 10% tax, all the *organization managers* are *jointly and severally liable* for the tax. However, the total tax collected cannot be more than 100% of the 10% tax. If the 25% tax imposed on the *disqualified person* were abated, the 10% tax would be abated automatically.

An *organization manager* who is also a *disqualified person* can be liable for the 25% tax as well as the 10% tax if he or she benefited from the *excess benefit transaction.*

The following are the standards for *knowing participation:*

i. Participation. Regs. 53.4958-1T(d)(3). *Participation* in an *excess benefit transaction* includes affirmative action and silence or inaction where the *organization manager* is under a duty to speak or act. However, an *organization manager* is not considered to have *participated* in an *excess benefit transaction* where the *organization manager* has opposed the transaction in a manner consistent with fulfillment of the *organization manager's* responsibilities to the *organization*.

ii. Knowing. Regs. 53.4958-1T(d)(4)(i). An *organization manager participates* in an *excess benefit transaction* <u>*knowingly*</u> if the *organization manager*:

   a. Has actual knowledge of sufficient facts so that based solely on these facts, the transaction would be an *excess benefit transaction*,

   b. Is aware the particular transaction may constitute an *excess benefit transaction*, <u>and</u>

   c. Negligently fails to make reasonable attempts to determine if the transaction is an *excess benefit transaction*, or is aware it is an *excess benefit transaction*.

   d. Exceptions to Knowing. Even though a transaction is subsequently determined to be an *excess benefit transaction*, an *organization manager's participation* in the transaction is not considered *knowing* if:

(1) After making full disclosure of the facts to an appropriate professional, the *organization manager* relies on the professional's reasoned written opinion regarding the elements of the transaction within the professional's expertise (Regs. 53.4958-1T(d)(4)(iii)), or

(2) The *organization manager* relies on the fact that the requirements for the *rebuttable presumption* of reasonableness have been satisfied (Regs. 53.4958-1T(d)(4)(iv)).

iii. Willful. Regs. 53.4958-1T(d)(5). Participation by an *organization manager* in an *excess benefit transaction* is *willful* if it is voluntary, conscious and intentional. To be *willful*, no motive to avoid the 10% tax is necessary. *Participation* by an *organization manager* is not *willful* if the *organization manager* does not know the transaction is an *excess benefit transaction*.

iv. Reasonable Cause. Regs. 53.4958-1T(d)(6). An *organization manager's participation* is due to *reasonable cause* if the *organization manager* has exercised responsibility for the *organization* with ordinary business care and prudence.

6. Correction. Regs. 53.4958-7T.

A *disqualified person* may *correct* an *excess benefit transaction* by:

i. Undoing the excess benefit to the extent possible, and
ii. Taking any additional measures necessary to place the *organization* in a financial position not worse than the position it would have been if the *disqualified person* had been dealing with the *organization* under the highest fiduciary standards.

Generally, a *disqualified person corrects* an *excess benefit transaction* by paying cash to the *organization* equal to the *correction amount*. But a *disqualified person* will not achieve *correction* if the *disqualified person* engaged in one or more transactions with the *organization* to circumvent the *correction* requirements.

The *disqualified person* may, if the *organization* agrees, make *correction* by returning to the *organization* the specific property it had previously transferred to the *disqualified person* in the *excess benefit transaction*. In that case, the *disqualified person* is treated as making cash payment to the *organization* equal to the lesser of the fair market value of the property on the date:

i. The property is returned, or

ii. The *excess benefit transaction occurred*.

If the payment resulting from the return of the property is less than the *correction amount*, *the disqualified person* must make additional cash payment to the *organization* equal to the difference. On the other hand, if the payment resulting from the return of the property exceeds the *correction amount*, the *organization* may make, but is not required to make, a cash payment to the *disqualified person* equal to the difference. But any *disqualified person* 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.

Correction Amount. The *correction amount* is the sum of the excess benefit and the interest on the excess benefit.

Interest. The amount of interest is determined by multiplying the excess benefit by the appropriate interest rate. Interest is compounded annually and is computed from the date the *excess benefit transaction occurred* to the date of *correction*. The interest rate must be at least the applicable Federal rate (AFR), compounded annually, for the month when the *excess benefit transaction occurred*. The period from when the *excess benefit transaction occurred* to the date of *correction* is used to determine the appropriate term of the AFR (short-term, mid-term or long-term).

Exemption Revoked. If the *organization* was tax-exempt under I.R.C. 501(c)(3), but it no longer exists or is not tax-exempt under I.R.C. 501(c)(3) on the date of *correction*, the *disqualified person* should make *correction* to another I.R.C. 501(c)(3) organization under the dissolution clause in the *organization's* organizational documents. However, the recipient I.R.C. 501(c)(3) organization must not be related to the *disqualified person*.

If the *organization* was tax-exempt under I.R.C. 501(c)(4), but it no longer exists or is not tax-exempt under I.R.C. 501(c)(4) on the date of *correction*, the *disqualified person* should make *correction* to a successor I.R.C. 501(c)(4) organization. If there is no successor tax-exempt organization, the *disqualified person* should make *correction* to any I.R.C. 501(c)(3) or I.R.C. 501(c)(4) organization that is not related to the *disqualified person*.

7. Abatement. Regs. 53.4958-1T(c)(2)(iii).

Under certain circumstances, the Service may abate the 25% tax and must abate the 200% tax. By providing for abatement, the tax law encourages *disqualified persons* to *correct* excess benefits rather than the Service collecting the 25% tax and the 200% tax.

The rules for abatement of the 25% tax appear in I.R.C. 4962(a) and the rules for abatement of the 200% tax appear in I.R.C. 4961(a).

i. 25% Tax. I.R.C. 4962.

The Service will not impose the 25% tax on an *excess benefit transaction* between a *disqualified person* and an *organization* if the *disqualified person*:

a. Has *corrected* the *excess benefit transaction* in the *correction period*, and

b. Can establish that the *excess benefit transaction* with the *organization* was due to *reasonable cause* and not to *willful neglect.*

If the 25% tax has already been imposed, the Service will not assess the tax, or if the 25% tax has already been assessed, the tax and interest will be abated.

c. Correction Period. Regs. 53.4963-1(e).

The *correction period* begins when the *excess benefit transaction* between a *disqualified person* and *organization occurs*, and ends 90 days after the Service mails a notice of deficiency to the *disqualified person* that includes the 200% tax. (A notice of deficiency is also known as a "Statutory Notice" or a "90-Day Letter.")

This 90 day period is extended while a petition involving I.R.C. 4958 taxes is pending in the U.S. Tax Court. This period may also be extended for any additional time the Service determines is reasonable and necessary to bring about *correction* of the excess benefit.

d. Reasonable Cause

Reasonable cause is not defined in I.R.C. 4962(a), nor is it defined in measurable terms elsewhere in the Code or regulations where a reasonable cause standard is imposed. There are guides, however, in the regulations and in many court cases that have considered if particular circumstances amounted to *reasonable cause*.

Regs. 53.4941(a)-1(b)(5) provides that a foundation manager's participation in an act of self-dealing is due to *reasonable cause* if he exercised his responsibility for the foundation with "ordinary business

care and prudence." Reg. 301.6651-1(c) provides that a failure to pay tax will be considered to be due to *reasonable cause* to the extent the taxpayer satisfactorily shows he or she exercised "ordinary business care and prudence" in providing for the payment of the tax liability, but was either unable to pay or would have suffered an undue hardship if the liability had been paid on the due date.

In U.S. v. Boyle, 469 U.S. 241 (1985), the executor of an estate exercised "ordinary business care and prudence" by engaging an attorney to file the estate tax return, but it was not *reasonable cause* to rely on the attorney to file the return timely. In John W. Madden, Jr. et al. v. Commissioner, T.C.M. 1997-395, the reliance by foundation managers on the advice of the CEO of a management company was not "ordinary business care and prudence."

Also, Regs. 53.4958-1T(d)(6) provides that an *organization manager's knowing participation* in an *excess benefit transaction* is due to *reasonable cause* if the *organization manager* has exercised responsibility for the *organization* with "ordinary business care and prudence."

Regs. 301.6724-1 provides that the penalty for a failure relating to an information reporting requirement is waived if the failure is due to "reasonable cause and is not due to willful neglect." Under this regulation, one element of "reasonable cause" is that the filer acted in a "responsible manner." This term means the filer exercised reasonable care, which is that standard of care a reasonably prudent person would use under the circumstances in the course of its business. Regs. 301.6724-1(d)(1)(i).

This standard is specifically adopted in the I.R.C. 4958 regulations for indicating an *organization*'s intent that a benefit was provided to a *disqualified person* as compensation in cases where an *organization* failed to report the benefit as otherwise required by the Code. Regs. 53.4958-4T(c)(3)(iii).

Under Regs. 301.6651-1(c) and other provisions that impose a reasonable cause standard, determining if reasonable cause was shown requires consideration of all the facts and circumstances.

e. Willful Neglect

I.R.C. 4962 does not define the term *willful neglect*. I.R.C. 6662(c) defines "negligence" for purposes of the negligence penalty as including any failure to make a reasonable attempt to comply with the provisions. In the generally accepted legal sense, negligence is the failure to do something a reasonable person, guided by those considerations that ordinarily regulate the conduct of human affairs, would do, or doing something a prudent and reasonable person would not do.

"Willful" is defined in several places; for example, Regs. 53.4941(a)-1(b)(4) defines "willful" as "voluntary, conscious, and intentional." Reg. 1.507-1(c)(5) provides that no motive to avoid the foundation restrictions is necessary to make an act or failure to act "willful," but that an act or failure to act is not "willful" if the foundation does not know it is an act to which the foundation rules apply.

Regs. 53.4958-1T(d)(5), relating to knowing participation by an *organization manager* in an *excess benefit transaction*, also defines "willful" as "voluntary, conscious, and intentional." This regulation also provides that no motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation "willful." However, *participation* by an *organization manager* is not "willful" if the *organization manager* does not know the transaction in which the *organization manager* is participating is an *excess benefit transaction*. So, the term *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.

A finding that a violation was caused by *willful neglect* will preclude abatement of the 25% tax, but a mere finding of no *willful neglect* does not, in itself, justify abatement. Numerous cases that have considered similar standards under I.R.C. 6651, concerning additions for failure to file a tax return or pay tax, have held that the mere absence of *willful neglect* is insufficient, since there must also be *reasonable cause* for the violation. See, for example, Rembusch v. Commissioner, T.C.M. 1979-73; de Belaieff v. Commissioner, T.C.M. 1956-273; Rogers Hornsby v. Commissioner, 26 B.T.A. 591 (1932). Ignorance of the law is a clear example of the operation of this principle. The fact that a *disqualified person* did not know a

transaction was an *excess benefit transaction* shows it was not due to *willful neglect*, but it does not meet the *reasonable cause* requirement.

ii. 200% Tax. I.R.C. 4961.

If the *disqualified person corrects* the *excess benefit transaction* in the *taxable period*, the Service will not impose the 200% tax. If the 200% tax has already been imposed, the Service will not assess the tax, or if the 200% tax has already been assessed, the tax and interest will be abated.

The *taxable period* (Regs. 53.4958-1T(c)(2)(ii)):

a. Begins when the *excess benefit transaction occurred*, and

b. Ends when a deficiency notice for the 25% tax is mailed to the *disqualified person*, or when the 25% tax is assessed on the *disqualified person*, whichever happens first.

i. Technical Advice

Area Offices are required to request technical advice from EO Technical when a *disqualified person* requests abatement of the 25% tax and the total 25% taxes involving all related parties and transactions within the period of limitations exceeds $200,000. Where several *disqualified persons* are *jointly and severally liable* for the 25% tax, the 25% tax is counted only once. Procedures regarding requesting technical advice are in Rev. Proc. 2001-5, 2001-1 I.R.B. 64. This revenue procedure is updated annually.

The Director, Exempt Organizations has the authority to abate the 25% tax. But where the total 25% tax involving all related *disqualified persons* and *excess benefit transactions* within the period of limitations is $200,000 or less, TE/GE Directors, Area Managers and Managers of TE/GE technical staffs have the authority to abate.

8. Period of Limitations. Regs. 53.4958-1T(e)(3).

The *period of limitations* for assessing I.R.C. 4958 excise taxes against *disqualified persons* and *organization managers* begins when the *organization* files its Form 990 for the period when the *excess benefit transaction occurred*, or when the Form 990 is due, whichever is later, and ends either three years or six years later.

i. 3 Years. If the *organization* filed Form 990 for the period when the *excess benefit transaction occurred* and adequately reported the *excess benefit transaction* on this return, the *period of limitations* would end three years later.

ii. 6 Years. If the *organization* filed Form 990 for the period when the *excess benefit transaction occurred* but did not *adequately report* the *excess benefit transaction* on this return, the *period of limitations* would end six years later.

An *excess benefit transaction* is *adequately reported* on Form 990 if it is disclosed in a manner sufficient to apprise the Service of the existence and nature of the *excess benefit transaction* with the *disqualified person* and, if applicable, the *participation* by the *organization manager*. The Service has the burden of proving that the disclosure of information on a return (or in a schedule or statement attached to the return) was insufficient to apprise the Service of the existence and nature of an *excess benefit transaction* with a *disqualified person* and *participation* by an *organization manager*.

iii. If the *organization* did not file Form 990 for the period when the *excess benefit transaction occurred*, the *period of limitations* would never end.

iv. Extending the Period of Limitations. Since the I.R.C. 4958 excise taxes are payable by the *disqualified person* or the *organization manager*, each *disqualified person* and each *organization manager* is considered a separate taxpayer. So, the Service and each *disqualified person* and *organization manager* may agree to extend the *period of limitations* for assessing I.R.C. 4958 taxes by each person executing a separate Form 872. Each 872 relates to each person's own tax year, not the tax year of the *organization*. If the spouse of a *disqualified person* or *organization manager* is also a *disqualified person* or *organization manager*, he/she should execute a separate Form 872; a "joint" Form 872 is not appropriate.

Because the *period of limitations* for assessing I.R.C. 4958 excise taxes against *disqualified persons* and *organization managers* begins when the *organization* files its Form 990, it is different from the *period of limitations* for assessing income taxes against a *disqualified person* or an *organization manager*.

9. Notice of Deficiency

When an Area Office sends a notice of deficiency for I.R.C. 4958 excise taxes, the Area Office should send each person who is liable for I.R.C. 4958 excise taxes a separate notice of deficiency. Also, each notice of deficiency should include:

i. All *excess benefit transactions occurring* in each of the tax years included in the notice, and

ii. Both the 25% tax and the 200% tax relating to each *excess benefit transaction* occurring in each year.

10. Penalties. Regs. 301.6684-1.

If a *disqualified person* or an *organization manager* is liable for I.R.C. 4958 excise taxes because of an act that is not due to *reasonable cause*, and the *disqualified person* or *organization manager* was either previously liable for I.R.C. 4958 excise taxes or the act is both *willful and flagrant*, the *disqualified person* or *organization manager* would be liable for a penalty of 100% of the applicable I.R.C. 4958 excise taxes.

D. Administrative Matters

1. Revocation. Regs. 53.4958-8T(a).

I.R.C. 4958 does not affect the standards for tax exemption under I.R.C. 501(c)(3) or I.R.C. 501(c)(4), such as the I.R.C. 501(c)(3) requirement that the *organization* be organized and operated exclusively for exempt purposes and the I.R.C. 501(c)(4) requirement that the *organization* be operated exclusively for the promotion of social welfare. Nor does I.R.C. 4958 affect the requirement under both I.R.C. 501(c)(3) of the Code and I.R.C. 501(c)(4) of the Code that no part of the *organization's* net earnings inure to the benefit of any private shareholder or individual. Whether a particular transaction is subject to I.R.C. 4958, the *organization* is still subject to the prohibition against impermissible private benefit.

In enacting I.R.C. 4958, Congress made it clear that the Service may impose intermediate sanctions for *excess benefit transactions* in lieu of, or in addition to, revocation of an *organization's* tax-exemption. But where the excess benefit does not rise to a level where it calls into question whether the *organization*, as a whole, functions as a tax-exempt organization, intermediate sanctions should be the sole sanction imposed. In practice, revocation of tax-exempt status would occur only when the *organization* no longer operates as a tax-exempt organization.

In determining whether to revoke the tax-exempt status of an *organization*, the Service will consider all the facts and circumstances, including these four factors:

i. Whether the *organization* has been involved in repeated *excess benefit transactions*.

ii. The size and scope of the *excess benefit transactions*.

iii. If, after concluding that the *organization* has been party to an *excess benefit transaction*, it has implemented safeguards to prevent future recurrences.

1. Whether there was compliance with other applicable laws.

The Service will publish additional guidance regarding the factors it will consider in determining when to revoke an *organization's* exemption as more experience is gained in administering this area. That guidance may specify additional factors or may revise the factors listed above.

2. Churches. Regs. 53.4958-8T(b).

In initiating and conducting any inquiry or examination into whether an *excess benefit transaction* has occurred between a church and a *disqualified person*, the procedures in I.R.C. 7611 should be used. The reasonable belief required to initiate a church tax inquiry is satisfied if there is a reasonable belief that an I.R.C. 4958 excise tax is due from a *disqualified person* for an *excess benefit transaction* involving a church. (See the appropriate section of the Exempt Organizations Examinations Guidelines Handbook relating to the restrictions on church tax inquiries and examinations under I.R.C. 7611.)

3. Technical Advice

Area Offices are required to request technical advice from EO Technical in cases where an I.R.C. 4958 excise tax is being proposed, in all I.R.C. 4958 cases being considered for resolution by a closing agreement, and in all cases where a *disqualified person* requests abatement of the 25% tax and the total 25% taxes involving all related parties and transactions within the period of limitations exceeds $200,000. Where several *disqualified persons* are jointly and severally liable for a 25% tax, the 25% tax is counted only once.) Procedures regarding requesting technical advice appear in Rev. Proc. 2001-5, 2001-1 I.R.B. 164. This revenue procedure is updated annually.

In appropriate circumstances, Area Offices should consider using the pre-submission conference procedures in Section 9 of Rev. Proc. 2001-5.

The Area Office should prepare a separate technical advice request for each *disqualified person* and for each *organization manager* who *knowingly participated* in an *excess benefit transaction.* When an Area Office submits a technical advice request under I.R.C. 4958, it should also submit a separate technical advice request for the *organization* relating to the issue of revocation of its exemption. In this request, the Area Office should explain its reasons for proposing or not proposing revocation of the *organization's* exemption, as the case may be. Similarly, if an Area Office submits a technical advice request proposing revocation of an *organization's* I.R.C. 501(c)(3) or I.R.C. 501(c)(4) exemption, it should also submit separate technical advice requests for any *disqualified persons* who entered into *excess benefit transactions* with the *organization* and for *organization managers* who *knowingly participated* in the *excess benefit transactions*, or it should explain its reasons for not submitting these requests.

In connection with any request for technical advice submitted to EO Technical, the Area Office should urge the *organization*, the *disqualified persons* and the *organization managers* to submit a written statement of the facts, issues and position.

Since an *excess benefit transaction* between a *disqualified person* and an *organization* may result in a *disqualified person* being liable for additional income tax, the Service Area Office may need to coordinate certain issues with the Wage and Investment Division or the Service operating division with jurisdiction over the *disqualified person.*

To permit EO Technical sufficient time to consider the request for technical advice, it may be necessary for the Area Office to request the *disqualified person* or the *organization manager* to consent to extending the period of limitations for assessing I.R.C. 4958 excise taxes. So, the Area Office should obtain from the appropriate persons executed Forms 872 (Consent to Extend the Time to Assess Tax). If the Area Office cannot obtain executed Form 872s from all appropriate persons to permit EO Technical sufficient time to consider the request for technical advice, the Area Office should contact EO Technical.

E. Fringe Benefits

The correct application of I.R.C. 4958 requires knowledge of the fringe benefit rules. A disqualified person may receive a variety of fringe benefits. The benefits need to be analyzed for two reasons.

1. To determine if compensation received by the disqualified person is reasonable.

2. To determine if the benefits received by the disqualified person are received in exchange for services rendered.

This portion of the article will explain how the temporary regulations treat fringe benefits. To make that discussion meaningful, some knowledge of fringe benefits is necessary. This section of the article consists of seven parts:

1. Fringe Benefit Taxation Generally.

2. Overview of I.R.C. 4958 and Fringe Benefits.

3. In-Depth Discussion of I.R.C. 132.

4. Fringe Benefits Subject to Other Statutory Exclusions.

5. Treatment of Fringe Benefits Not Excludable From Income.

6. Valuation of Fringe Benefits.

7. Employment Tax Treatment of Fringe Benefits.

Part 1 – Fringe Benefit Taxation Generally

The general rule is all fringe benefits are taxable. I.R.C. 61(a)(1) provides that gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. The regulations under I.R.C. 61 explain how it operates with Code sections that provide specific exclusions for certain fringe benefits.

Regs. 1.61-21(b) provides that to the extent a particular fringe benefit is specifically excluded from gross income under another section of subtitle A, that section will govern the treatment of that fringe benefit, not I.R.C. 61. So, if the requirements of the governing section are satisfied, the fringe benefit may be excluded from gross income.

I.R.C. 61 and the individual sections that provide deductibility or excludability are complex. Knowing I.R.C. 132 -- a "laundry list" of fringe benefits excluded from gross income -- is important to correctly apply I.R.C. 4958. I.R.C. 132 includes:

- No-additional-cost service
- Qualified employee discount
- Working condition fringe benefits
- *De minimis* fringe benefits
- Qualified transportation fringe benefits
- Qualified moving expense reimbursement

The working condition fringe benefit rule in I.R.C. 132(a)(3) is an example of the complexity in this area. That section is cross referenced to the ordinary and necessary business expense rules of I.R.C. 162 and the depreciation rules of I.R.C. 167.

I.R.C. 132(d) defines a "working condition fringe" as "property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under sections 162 or 167."

This reference to I.R.C. 162 does not complete the process. Congress added I.R.C. 274, effective January 1, 1963. I.R.C. 274 disallows in whole, or in part, certain expenditures for entertainment, gifts and travel that would otherwise be allowable under Chapter 1 of the Code (*i.e.*, I.R.C. 162 or 167). For example, a lavish or extravagant entertainment expense might be deductible under I.R.C. 162, but is disallowed as a deduction under I.R.C. 274.

The I.R.C. 274 requirements are in addition to the requirements for deductibility imposed by other Code provisions. If a deduction is claimed for any expenditure for entertainment, gifts, or travel, the taxpayer must first establish it is allowable as a deduction under Chapter 1 of the Code before the provisions of I.R.C. 274 become applicable. The regulations make it clear that I.R.C. 274 is a disallowance provision and does not make deductible any expense disallowed under any other Code provision.

I.R.C. 162(a) provides that a deduction will be allowed for all the ordinary and necessary expenses paid or incurred in the taxable year in carrying on any trade or business. I.R.C. 162(a)(1) permits a reasonable allowance for salaries or other compensation for personal services actually rendered. I.R.C. 162(a)(2) permits a deduction for travel expenses; including meals and lodging that are not lavish and extravagant. Thus I.R.C. 162(a)(2) ties in with I.R.C. 274.

I.R.C. 132 applies only to benefits provided directly by the employer to the employee; it does not deal with reimbursements by the employer to the employee for business expenses initially paid by the employee. For example, I.R.C. 132 treats as an excludable working condition fringe the value of an airplane ticket the employer gives to the employee to make a business trip. I.R.C. 132 does not cover reimbursement paid by the employer to the employee if the employee purchases the airline ticket for the business trip. Reimbursements are technically covered by Regs. 1.62-2. However, for administrative purposes, all TE/GE administrative personnel will treat reimbursements of a business expense the same as if the expense were paid directly by the employer, as long as the employee complies with the substantiation rules of I.R.C. 62 and 274. So qualifying reimbursements will be disregarded under I.R.C. 4958, to the same extent as direct payments by the employer are disregarded under I.R.C. 132.

Part 2 - Overview of I.R.C. 4958 and Fringe Benefits

Knowledge of fringe benefits is important to answer two questions for purposes of I.R.C. 4958.

1. Is the compensation received by the disqualified person reasonable?

This question is important to determine if the disqualified person has received an excess benefit. To determine if compensation received by the disqualified person that includes fringe benefits is reasonable, the regulations start with the definition of reasonable compensation. Regs. 53.4958-4T(b)(1)(ii)(A) contains the definition of reasonable compensation.

> In general. The value of services is the amount that would ordinarily be paid for like services by like enterprises under like circumstances (i.e., reasonable compensation). I.R.C. 162 standards apply in determining reasonableness of compensation, taking into account the aggregate benefits (other than any benefits specifically disregarded under paragraph (a)(4) of this section).

Regs. 53.4948-4T(a)(4) contains a list of economic benefits that are disregarded for purposes of I.R.C. 4958 and the calculation of reasonable compensation. On that list are benefits provided to volunteers, to members or donors, to charitable beneficiaries and to governmental units. For this discussion, the important provision is Regs. 53.4958-4T(a)(4)(i), which generally deals with fringe benefits provide to employees, partners, and contractors.

An economic benefit excluded from income under section 132 -- except any liability insurance premium, payment, or reimbursement that must be taken into account under Regs. 53.4958-4T(b)(1)(ii)(B)(2) -- is disregarded for purposes of 4958.

The first question is now answered. If a disqualified person receives a benefit from an employer, it must normally be tested under the reasonable compensation standard of Reg. Sec. 53.4958-4T(b)(1)(ii)(A). But if a disqualified person receives one or more of the benefits listed in I.R.C. 132 (including Regs. 1.62-2), the income received from those benefits will not be included in the calculation of reasonable compensation. This means all other fringe benefits need to be taken into consideration in calculating reasonable compensation. If a benefit is excluded by I.R.C. 132 but the disqualified person also received benefits used for personal purposes (*e.g.*, business use and personal use of employer-provided car), the value of the personal benefit will be included in the calculation of reasonable compensation even though the business use is disregarded.

2. Did the disqualified person receive the benefits in exchange for services rendered?

Regs. 53.4958-4T(a)(1) provides an excess benefit transaction means 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 (including the performance of services) received for providing the benefit.

The key concept here is that an excess benefit is based on the value of the economic benefit exceeding the value of the consideration the disqualified person provides. The economic benefit must be received in exchange for consideration. The regulations make it very clear that it must be intended that the benefit be a part of compensation.

Regs. 53.4958-4T(c)(1) provides the general rule that an economic benefit is not treated as consideration for the performance of services unless the organization providing the benefit clearly indicates its intent to treat the benefit as compensation when the benefit is paid. Intent is shown only if the organization provides written substantiation that is contemporaneous with the transfer of the economic benefit.

The exception to the rule is for certain fringe benefits. If the fringe benefit is excluded from income by any provision of the Internal Revenue Code (*e.g.*, I.R.C. 132 or I.R.C. 119) substantiation is not required. The following is a road map for sorting through the benefits received by the disqualified person.

i. Identify the disqualified persons.

ii. Identify all the benefits, monetary and nonmonetary received by each disqualified person.

iii. Identify the benefits to be tested under the exclusion provisions of chapter 1 of Subtitle A.

a. Test each provision.

b. Isolate the benefits that qualify for exclusion under I.R.C. 132 (including Regs. 1.62-2). If the benefits received by the disqualified person fully qualify, they are completely disregarded under I.R.C. 4958. Any benefits described in I.R.C. 132 that do not qualify under I.R.C. 132 are included in the reasonable compensation calculation if substantiated as compensation. Any written evidence that the benefits were intended as excludable compensation is sufficient substantiation (for example: a contract; board minutes; or an employee handbook; or

an opinion by a benefits company, an attorney, a C.P.A., or an enrolled agent that the benefits are excludable from income.) If there is substantiation, but upon examination, the Service determined that the benefits fail to qualify, then the failed benefits will be treated as having been substantiated as compensation and will be included in the reasonable compensation calculation. All unsubstantiated failed benefits are excess benefits under I.R.C. 4958.

c. Isolate the benefits that qualify for exclusion under any provision in the Code other than I.R.C. 132 (such as I.R.C. 119). Qualified benefits are not disregarded under I.R.C. 4958. They are included in the reasonable compensation calculation and need not be substantiated. Any benefits claimed to be excludable that do not qualify or that have a taxable component are included in the reasonable compensation calculation if substantiated, but are excess benefits under I.R.C. 4958 if not substantiated. Any written evidence that the benefits were intended as excludable compensation is sufficient substantiation (for example: a contract; board minutes; or an employee handbook; or an opinion by a benefits company, an attorney, a C.P.A., or an enrolled agent that the benefits are excludable from income.)

d. Any benefits not excluded from income under the Code are excess benefits under I.R.C. 4958 unless they are substantiated. If substantiated, they are included in the reasonable compensation calculation.

If a statutory exclusion is available for a particular fringe benefit, the requirements of that Code section must be met for the exclusion to apply. For example, if the statutory exclusion has a restriction against providing the benefit in cash, the fringe benefit is not excludable if cash or a cash equivalent such as a gift certificate is provided.

A "failed" fringe benefit is treated as any other form of compensation subject to the reasonable compensation requirements of I.R.C. 4958. As with all forms of consideration, only consideration contemporaneously substantiated can be included in the reasonable compensation calculation.

The applicable statutory exclusion for a fringe benefit may have a provision that limits the dollar amount of the benefit or requires a written plan. The provision must be satisfied for the fringe benefit to be excludable from taxation under that I.R.C. section.

Finally, it is important to remember that, even if a statutory exclusion applies, the result may be that the value of the fringe benefit is only partially excludable from the

employee's gross income. For purposes of I.R.C. 4958, part of the benefit amount may be disregarded and it may be necessary to consider part of the benefit in the reasonable compensation analysis.

Note: The word "substantiation" has two uses for purposes of I.R.C. 4958. When used in the statutory exclusion provisions, such as I.R.C. 132, substantiation refers to keeping adequate books and records to support the exclusion. When used in I.R.C. 4958 it refers to evidence that fringe benefits were intended to be part of the compensation package. In an effort to be clear, the article will refer to the I.R.C. 4958 use as substantiation of compensation.

Part 3 – In-Depth Discussion of I.R.C. 132

A fringe benefit that satisfies the requirements for income exclusion under I.R.C. 132 is totally disregarded for I.R.C. 4958 purposes. I.R.C. 132 was added to the Code in 1984 to explicitly exclude four commonly provided fringe benefits. Two other exclusions have since been added. There are now specific statutory exclusions for working condition fringes, *de minimis* fringes, qualified employee discounts, no-additional-cost services, qualified transportation fringes, and qualified moving expense reimbursements.

A. Working Condition Fringe Benefits

I.R.C. 132(d) and I.R.C. 1.132-5 of the regulations defines a working condition fringe as any property or services provided to an employee to the extent that, if the employee paid for the property or services, the payment would be allowable as a deduction under I.R.C. 162 or 167. I.R.C. 132(d) excludes from the gross income of an employee the value of work related items provided by the employer so the employee can perform his or her job.

Common working condition fringes are desks, computers and office space. This exclusion applies only if (1) the employee's use of the property relates to the employer's business, and (2) the business use is substantiated by adequate records or sufficient evidence corroborating the employee's own statement. Regs. 1.132-5(c).

On audit, the most common working condition fringe is likely to be the use of an automobile for business purposes. Other commonly seen working condition fringes will be use of entertainment facilities, business travel and entertainment, and spousal or dependent travel for business purposes.

In general, the test for whether a fringe benefit will be excluded under I.R.C. 132(a)(3) (including Regs. 1.62-2) and disregarded under I.R.C. 4958 is determined by I.R.C. 162, 167 and (in appropriate cases) I.R.C. 267. The following three steps should be followed:

- Analyze the payment as if the employee had used the money to purchase the goods or services directly.

- Determine if the cost of the benefit would have been deductible by the employee under I.R.C. 162 as an ordinary and necessary business expense or depreciated under I.R.C. 167.

- If the expenditure is for travel, entertainment, or business gifts, determine if the expenditure must be disallowed as a business expense under I.R.C. 274.

For purposes of this test, limitations on employee deductions, such as the two-percent adjusted gross income threshold are ignored. However, I.R.C. 132 has many special rules for exclusion from income taxes, and these apply in determining if the benefit is disregarded for purposes of I.R.C. 4958.

Unlike other exclusions that apply only to employees, the working condition fringe exclusion is generally available to independent contractors, partners, and directors. Regs. 1.132-1(b)(2). There are no nondiscrimination rules for working condition fringes. Regs. 1.132-5(q). So, the benefits may be provided to some employees and not to others.

Additional requirements apply to certain types of working condition fringe benefits, such as the use of an automobile for security purposes. *See, e.g.*, Regs. 1.132-5(m), as amended by T. D. 8457, 1992-2 C.B. 12.

1. Use of Employer-Provided Automobiles

An employee's use of a vehicle for the employer's business purposes will be excluded from the employee's income as a working condition fringe benefit if the use is properly substantiated. In such circumstances, the benefit is disregarded under I.R.C. 4958 and no valuation is necessary and the business related use of the vehicle is excluded under I.R.C. 132 and disregarded for purposes of I.R.C. 4958.

Any personal use of the vehicle (including use of chauffeur services) must be valued and included both in income and the calculation of reasonable compensation for I.R.C. 4958 purposes. Whatever valuation rule is used, if the rule results in the employee or contractor realizing additional income, that income is a benefit that must be considered in determining excess benefits for I.R.C. 4958.

The general rule of valuation is fair market value. But an employer may use special valuation rules to value an employee's automobile use. If a special valuation rule is not properly applied or if it is used to value a fringe benefit by a taxpayer not entitled to use the rule, the taxpayer must determine FMV under the general valuation rules. Regs. 1.61-21(c)(5).

There are three valuation methods: the annual lease valuation rule (ALV), the cents-per-mile valuation rule, and the commuting valuation rule. Chauffeur services are valued differently. The four rules are discussed below. For I.R.C. 4958 purposes in the absence of substantiation, the agent should determine the value of the vehicle using the following method.

Value should be determined by the amount an individual would have to pay in an arm's-length transaction to lease the same or comparable vehicle on the same or comparable conditions in the geographic area where the vehicle is available for use. Regs. 1.61-21(b)(4).

For example, if a DP's salary is excessive by $100,000 and his personal use of an organization's automobile is valued at $6,000, then the total excess benefit taxed under I.R.C. 4958 will be $106,000.

a. Employer Provided Automobile: Annual Lease Valuation Rule

An employer may value an employee's personal use of an automobile by reference to the Annual Lease Value (ALV) of the automobile. A table provided in Regs. 1.61-21(d) determines the ALV. by the fair market value of the automobile (plus sales tax and title fees) on the first date it is available for employee use.

Safe harbor rules for determining FMV for purposes of the ALV are provided in Regs. 1.61-21(d)(5), as supplemented by Notice 89-110. For example, the ALV for an automobile with a fair market value of $25,000 is $6,850.

The amount taxed to the employee is determined first by multiplying the ALV by the employee's business use percentage. The business use percentage is the number of miles driven for the employer's business as a percentage of the employee's total annual mileage. The amount taxed to the employee is the difference between the ALV after performing the calculation: Amount Taxed = ALV (business mileage/total annual mileage)

For example, if the ALV is $5,000 and the employee's business use percentage is 70%, the employee would exclude from income $3,500 (70% of $5,000) and be taxed on $1,500 ($5,000 less $3,500).

The ALV includes insurance and maintenance, but does not include fuel provided by the employer. Regs. 1.61-21(d)(3). Fuel provided in kind may be valued at 5.5 cents per mile for each mile the vehicle is driven in the United States. Where the cost of fuel is reimbursed by or charged to the employer, the value is based generally on the amount of the actual reimbursement.

The ALV of an automobile is recalculated every four years. In general and except for any year when the commuting valuation rule is used, the ALV rule must be used the first day the automobile is provided to the employee for personal use and must be used for all subsequent years. Regs. 1.61-21(d)(7).

The employer has the option of including the total ALV in the employee's gross income, instead of excluding any portion that qualifies as a working condition fringe. This option is available only if the employer is using the ALV rule. Regs. 1.132-5(b)(1)(iv).

b. Employer-Provided Automobile: Cents-Per-Mile Valuation Rule

Under this valuation rule, an employer uses the standard mileage rate (*e.g.*, 32.5 cents per mile per mile in 2000, and 34.5 cents per mile in 2001) to value the number of miles driven by the employee for personal purposes. Regs. 1.61-21(e). This rule is available if:

- The employer reasonably expects the vehicle will be "regularly used" in the employer's business throughout the calendar year; or the vehicle is driven primarily by employees for at least 10,000 miles in a calendar year; and

- The fair market value of the vehicle does not exceed $12,800, as indexed ($15,400 in 2001). The figures are updated annually in a revenue procedure issued early in the calendar year. (Rev. Proc. 2001-19, 2001-9 I.R.B. 732.)

Whether a vehicle is considered regularly used in the employer's trade or business depends on the particular facts and circumstances. Under safe harbor rules, the regular use requirement is met if at least 50% of the vehicle's total annual mileage is for the employer's business, or the vehicle is generally used each workday to transport at least three employees to and from work in an employer-sponsored commuting vehicle pool.

The cents-per-mile value includes the cost of maintenance, insurance and fuel provided by the employer. Regs. 1.61-21(e)(3).

The cents-per-mile rule must be used the first day the automobile is provided to the employee for personal use and must be used for all subsequent years in which the vehicle qualifies for use of the rule. Regs. 1.61-21(e)(5).

c. Employer-Provided Automobile: Commuting Valuation Rule

The commuting use of an employer-provided vehicle is valued at $1.50 per one-way commute if all the following conditions are met. Regs. 1.61-21(f).

- The vehicle is owned/leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business and is used in the employer's trade or business;

- The employer, for *bona fide* noncompensatory business reasons, requires the employee to commute to and from work in the vehicle;

- The employer has established a written policy under which the employee may not use the vehicle for personal purposes other than for commuting or *de minimis* personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home);

- The employee, except for *de minimis* personal use, does not use the vehicle for any personal purpose other than commuting; and

- The employee required to use the vehicle for commuting is not a "control employee" (see definition below) of the employer.

The $1.50 per one-way commute amount is includable in the income of each employee riding in a car or vanpool. Regs. 1.61-21(f)(3). The $1.50 commuting value includes the value of insurance, maintenance, and fuel.

An employer-provided vehicle that is generally used each workday to transport at least three employees to and from work in an employer-sponsored vanpool is deemed to meet the first and second requirements of the commuting valuation rules. Regs. 1.61-21(f)(1).

The rule may not be used to value the commuting use of a chauffeur-driven vehicle. Regs. 1.61-21(f)(2)(i).

Under Regs. 1.61-21(f)(5) and Regs. 1.61-21(f)(7), a "control employee" of a non-governmental employer is an employee who meets one of the following criteria:

- Is a board-appointed, shareholder-appointed, confirmed, or elected officer of the employer whose compensation equals or exceeds $50,000 as indexed ($75,000 for 2000 and 2001). Notice 2006-6, 2000-2 C.B. 600.

- Is a director of the employer;

- Owns a 1% or greater equity, capital or profit interest in the employer; or

- Receives $100,000 or more in annual compensation as indexed ($150,000 in 2000 and 155,000 in 2001.) *Id*.

Under Regs. 1.61-21(f)(6) and Regs. 1.61-21(f)(7), a "control employee" of a government employer is either:

- An elected official; or

- An employee whose annual compensation is at least as great as a federal government employee at Executive Level V ($108,200 for 1995 through 1997; $110,700 for 1998 through 2000, $125,700 for 2001.).

d. Employer-Provided Automobile: Chauffeur Services

There are no special valuation rules available for valuing the personal use of chauffeur services, such as for commuting. So, the value of chauffeur services for personal use may be valued either by reference to:

- The FMV of the services as determined in an arm's length transaction, or

- The compensation of the chauffeur.

The amount of time a chauffeur is "on call" to perform driving services is included in the value of the services under either method. Regs. 1.61-21(b)(5).

If a chauffeur drives an employee for both business and personal purposes, the value of the services includable in the employee's income is based on the amount of time the chauffeur spends driving (or is on call to drive) the employee for personal reasons. The value of the personal use portion is included in the employee's gross income. If the substantiation as compensation rules are met, the amount is included in the reasonable compensation analysis. If the substantiation rules are not met, the amount is not part of compensation and is considered an excess benefit.

2. Employee Use of Organization Airplane

The regulations under I.R.C. 132 do not contain any special rules for distinguishing business and personal use of an organization's airplane. Instead, the regulations contain a cross-reference to the "Non-commercial flight valuation rules" in Regs. Sec. 1.61-21(g). As with all other I.R.C. 132 benefits, business use is disregarded for I.R.C. 4958 purposes and the personal use of the airplane is taxable and includable in the excess benefits computation if substantiated as compensation.

A detailed explanation of these regulations is beyond the scope of this article. However, note that some automobile valuation rules allow incidental personal use without tax or inclusion in the I.R.C. 4958 excess benefits computation. Regs. 1.61-21(g) does not provide any incidental use exceptions for personal use of an airplane.

3. Reimbursement for Business Travel and Entertainment Expenses

All payments or reimbursements by an organization to an employee (including reimbursements for business travel or entertainment expenses) will be treated as a working condition fringe excludable from income and disregarded under I.R.C. 4958 if the requirements of Regs. 1.62-2(c) are satisfied. The following is a brief summary of those requirements.

Reimbursement plans are generally divided into accountable and nonaccountable plans:

- *Accountable Plans*

If the employer maintains an accountable plan, all reimbursements to the employee for business expenses are excluded from the employee's income and are disregarded under I.R.C. 4958. To be an accountable plan, the employer's reimbursement or allowance arrangement must include all three of the following:

(1) The employee's expenses must have a business connection—that is, the employee must have paid or incurred deductible expenses while performing services as an employee of the employer.

(2) The employee must adequately account to the employer for these expenses within a reasonable period.

(3) The employee must return any excess reimbursement or allowance within a reasonable period.

Any expenses that fail to meet all three of the above rules are treated as having been reimbursed under a nonaccountable plan (discussed below). If the employee is reimbursed for expenses that are not deductible business expenses—for example, travel that is not away from home—those reimbursements are also treated as paid under a nonaccountable plan.

As noted in paragraph (2) above, under an accountable plan the employee must adequately account to the employer for the employee's expenses. The employee adequately accounts by giving the employer a statement of expense, an account book, a diary, or a similar record in which the employee has entered each expense at or near the

time it was incurred, along with documentary evidence (such as receipts) of the travel, mileage, and other employee business expenses.

The employee must also account for all amounts he or she received in the year as advances, reimbursement, or allowances. This includes amounts the employee charged to the employer by credit card or other method. The employee must provide to the employer the same type of records and supporting information the employee would have to give to the IRS if the IRS questioned a deduction on the employee's return. The employee must pay back the amount of any reimbursement or other expense allowance for which the employee did not adequately account or that is more than the amount for which the employee accounted.

If the employee reimburses the employee for expenses under a per diem or car allowance, the employee can generally use the allowance as proof for the expenses. A per diem or car allowance satisfies the adequate accounting requirement for the employee's expenses only if all four of the following conditions apply:

(1) The employer reasonably limits payments of the travel expense to those that are ordinary and necessary in the conduct of the trade or business.

(2) The employee proves the time (dates), place, and business purpose of the employee's expense to the employer within a reasonable period.

(3) The employee is not related to the employer. If the employee is related to the employer, the employee must be able to prove the expenses to the IRS even if the employee has already adequately accounted to the employer and returned any excess reimbursement.

(4) The allowance is similar in form to and not more than the federal rate.

The federal rate can be figured using any of the following methods.

(1) The regular federal per diem rate.

(2) The standard meal allowance.

(3) The high-low rate.

(4) For car expense, either the standard mileage rate or a fixed and variable rate (FAVR).

The "regular per diem rate" is the highest amount the federal government will pay to its employees for lodging, meal and incidental expenses (or meal and incidental expense

only) while they are traveling away from home in a particular are. The rates are different for different locations. Publication 1542 gives the rates in the continental United States (CONUS) for the current year. The State Department Internet site gives the rates for foreign areas ("OCONUS").

The "standard meal allowance" is the federal rate for meal and incidental expenses (M&IE). The rate for most small localities in the United States is $30. Most major cities and many other localities qualify for higher rates. See Publication 1542 for CONUS and the State Department Internet site for OCONUS.

The employee receives an allowance only for meals and incidental expenses when the employer does one of the following:

(1) Provides the employee with lodging in kind.

(2) Reimburses the employee, based on receipts, for the actual cost of the employee's lodging.

(3) Pays the hotel, motel, etc. directly for the lodging.

(4) Does not have a reasonable belief that the employee had lodging expenses, such as when the employee stays with friends or relatives.

(5) Computes the allowance on a basis similar to that used to compute the employee's compensation, such as hours worked or miles traveled.

The "high-low rate" mentioned above is a simplified method of computing the federal per diem rate for travel within the continental United States. It eliminates the need to keep a current list of the per diem rate for each city. Under the high low method, the per diem amount for travel in 2000 is $201 (including $42 for M&IE) for certain high cost locations. All other areas have a per diem amount of $124 (including $34 for M&IE). *See* Publication 1542.

The "standard mileage rate," mentioned above, is a set rate per mile that the employee can use to compute deductible car expenses. For 2000, the standard mileage rate was 32.5 cents per mile; for 2001, the rate is 34.5 cents per mile.

The "fixed and variable rate" (FAVR) mentioned above is an allowance the employer may use to reimburse the employee's car expenses. Under this method, the employer pays an allowance that includes a combination of payments covering fixed and variable costs, such as a cents-per-mile rate to cover the employee's variable operating costs (such as gas, oil, etc.) plus a flat amount to cover the employee's fixed costs (such as depreciation, lease payments, insurance, etc.

The employee's reporting of reimbursements under an accountable plan will depend on whether the expenses were more or less than the federal rate. If the reimbursements were less than or equal to the federal rate, the reimbursements will not be included on the employee's Form W-2. The employee need not report the expenses or the reimbursements on the employee's Form 1040. The reimbursements may be disregarded under I.R.C. 4958.

If the actual business expenses are more than the reimbursements, the employee may complete Form 2106 and deduct the excess amount on Form 1040, Schedule A. Properly deducted amounts may be disregarded under I.R.C. 4958.

If the reimbursements were more than the federal rate, the employer must include the reimbursement amount in excess of the federal rate in Box 1 of the employee's Form W-2. The employee must report this amount as income from wages. The excess reimbursements must be tested for reasonableness and substantiated as compensation under I.R.C. 4958. If the excess reimbursements are not substantiated, they are automatically excess benefits under I.R.C. 4958.

- *Nonaccountable Plans*

A nonaccountable plan is a reimbursement or expense allowance arrangement that does not meet the rules for accountable plans discussed above. If there is a nonaccountable plan, the employer should combine the amount of any reimbursement or other expense allowance paid to the employee under a nonaccountable plan with wages, salary or other pay in box 1 of the Form W-2.

If the employer uses a nonaccountable plan, the employee may be able to deduct some or all the business expenses on Form 2106 and file it with the Form 1040. See Publication 17 and the instructions to Form 2106 for detailed rules. To the extent an employee on a nonaccountable plan fails to satisfy the deduction and reporting rules as embodied in Form 2106, the reimbursements are not covered by Regs. 1.62-2(c) or I.R.C. 132, and the reimbursements may not be disregarded. The reimbursements must instead be tested for reasonableness and substantiation as compensation like any other payment by the exempt organization to a disqualified person.

For example, assume an organization sends an employee on a trip to Paris to attend a convention. The employee spends seven days on business, and seven extra days in Paris engaging in personal activities. The organization mistakenly pays all the expenses of the trip, including the seven extra days. The employer is on an accountable plan and the employee satisfies all the requirements for accountable plan substantiation for the first seven days of the trip, but does not return the reimbursement for the seven nonbusiness days. The reimbursement for the seven business days may be disregarded for purposes of I.R.C. 4958. The expenses of the seven extra days would not satisfy the requirements for

an accountable plan, and the employee could not deduct the expenses on the employee's Form 1040. So, any reimbursements for those expenses would be includable in the employee's income and wages and would be added to the I.R.C. 4958 reasonable compensation analysis.

4. Social Club Dues Paid by Organization

Regs. 1.132-5(s) provides two alternative tax treatments for dues paid by the employer for the benefit of an employee.

Assume that a club whose dues are paid by an organization is used 40 percent for business and 60 percent for personal purposes by a disqualified person.

Under the first alternative, the organization could choose to treat the entire amount as compensation to the DP. In that event, the entire amount of the dues would be taxable to the disqualified person and would be added in an I.R.C. 4958 reasonable compensation computation.

Alternatively, and more likely, the organization could treat the 40 percent business use as a working condition fringe. The organization would then report the 60 percent of the dues, representing the nonbusiness use, as compensation to the disqualified person, and such amount would be taxable and added to the reasonable compensation computation. *See* Regs. 1.132-5(s), Examples (1) and (2).

5. Spouse and Dependent Travel

Organizations often pay the travel expenses of the spouse or dependents of employees when the employee is traveling on organization business. Regs. 1.132.5(t) allows two alternative methods of handling such expenditures for tax purposes.

First, the organization may add the cost of such travel to the employee's compensation. In that event, the entire amount of the additional compensation would be taxable to the disqualified person and be includable in the excess benefits computation under I.R.C. 4958.

Alternatively, the organization may seek to have all or part of the expenditures treated as a working condition fringe benefit. If the requirements of I.R.C. 132 are met the benefit will be disregarded for purposes of I.R.C. 4958. The benefit will qualify under I.R.C. 132 if it can be adequately demonstrated that the spouse's, dependent's, or other accompanying individual's presence on the employee's business trip has a bona fide business purpose, and if the employee substantiates the travel expenses under Code Secs. 162 and 274.

Normally, it is very difficult for an organization to prove it had a bona fide business purpose for paying or reimbursing the costs incurred by spouses accompanying disqualified persons on business trips. The courts have used a two-step analysis.

(1) The dominant purpose must serve the employer's business.

(2) The spouse must actually spend a substantial amount of time assisting the accomplishment of the employer's purpose. Danville Plywood Corp. v. United States, 899 F.3d 3 (Fed. Cir. 1990), quoting United States v. Disney, 413 F.2d 783, 788 (9th Cir. 1969).

"The spouse's performance of an incidental service does not meet the requirement." Danville, supra, at 14. For example, performance of social functions (such as socializing with the spouses of business associates) does not satisfy the bona fide business purpose test. The same principles would apply for excluding the travel expenses of dependents of the disqualified person.

If the bona fide business purpose test is not satisfied respecting a spouse or dependent, the entire amount of the expense attributable to those persons would be taxable and includable in the excess benefits computation of the disqualified person. The spouse and dependents may be jointly and severally liable for the I.R.C. 4958 taxes to the extent of the excess benefits each received. However, automobile, hotel room, and other fixed costs do not have to be shared evenly between the disqualified person and the spouse and dependents.

For example, if the disqualified person normally travels to the business site in an automobile, and rents a hotel room, then the costs of the automobile travel and the hotel room need not be allocated between the disqualified person and the accompanying spouse or dependents. If the hotel charges a fee for additional persons in the room, only that additional fee would be includable in the excess benefits computation.

6. Personal Use of Office Credit Card

Any use of the office credit card for personal purposes is taxable as income to the employee. The value of such personal use is an automatic excess benefit unless it is substantiated as compensation.

7. Other Working Condition Fringe Benefits

Personal use of the employer's resources does not qualify as I.R.C. 132 working condition fringe benefits. Some examples are, non-*de minimis* personal use of cell phones, substantial use of office copying machines for personal use, and personal use of

organization employees to perform substantial personal work (*e.g.*, use of office cleaning personnel to clean a disqualified person's residence).

The value of these benefits constitutes automatic taxable excess benefits unless there is substantiation as compensation.

B. *De Minimis* Fringe Benefits

1. General Rules

A *de minimis* fringe benefit is any property or service of a value so small (after taking into account the frequency that similar fringes are provided by the employer to the employer's employees) to make accounting for it unreasonable or administratively impracticable. I.R.C. 132(e).

The *de minimis* fringe exclusion applies to any recipient of the fringe benefit, and not just employees. Regs. 1.132-1(b)(4). Generally, frequency is determined on an individual recipient basis. Benefits that qualify as *de minimis* fringes are disregarded for purposes of I.R.C. 4958.

Regs. 1.132-6(e)(1) provides the following examples of *de minimis* fringe benefits:

- Occasional sporting event tickets
- Local telephone calls
- Coffee, doughnuts and soft drinks
- Traditional birthday or holiday gifts
- Occasional cocktail parties, group meals or picnics for employees and their guests
- Flowers, fruit, books, or similar property provided under special circumstances (e.g., because of illness, outstanding performance, or family crisis).

The Service has not established a bright line test for determining if an item is *de minimis*. In other words, there is no threshold amount below, which everything is *de minimis* and above which nothing is *de minimis*.

However, group-term life insurance on the life of an employee's dependent is excludable from income as a *de minimis* fringe if the face amount of the insurance does not exceed $2,000. Insurance provided in excess of this amount may or may not be excluded from income, depending on the cost of the insurance over the amount paid by the employee (on an after tax basis). *See* Notice 89-110, 1989-2 C.B. 447.

Regs. 1.132-6(e)(2) provides the following examples of benefits that do not qualify for exclusion as *de minimis* fringes:

- Cash (except for occasional meal money and local transportation fare provided because overtime work necessarily extended the employee's work schedule)
- Cash equivalents, such as gift certificates or a savings bond
- Season tickets to sporting or theatrical events
- Commuting use of an employer's car for more than one day per month
- Memberships in private athletic or country clubs, regardless how frequently the employee uses the facility
- Use of an employer's apartment, hunting lodge, boat, etc. for a weekend

Caution: Items chosen by employees under a catalog award program are generally not *de minimis* fringe benefits because the catalog award is viewed as a cash equivalent due to its similarity to a gift certificate. So, whether the value of the items available in the catalog would otherwise be considered nominal is irrelevant.

If an employer provides a benefit that exceeds the value or frequency limits applicable for the *de minimis* fringe exclusion to apply, the entire benefit is taxed to the employee, not just the portion that exceeds the *de minimis* limits. Regs. 1.132-6(d)(4). The value of the benefit is automatically an excess benefit unless substantiated as compensation.

There are no nondiscrimination requirements that apply to *de minimis* fringe benefits. Regs. 1.132-6(f). So, an employer may provide the benefits to some employees and not to others.

2. Eating Facilities

Many employers often offer discounts on the cost of meals for employees. The value of meals provided at a discount to employees at an employer-operated eating facility is excludable from an employee's income if certain conditions are met. *See* I.R.C. 132(e); Regs 1.132-7(a).

(1) On an annual basis, the revenue from the facility must equal or exceed its direct operating costs;
(2) The facility must be owned or leased by the employer and operated by the employer (or a third party contractor);
(3) The facility must be located on or near the employer's business premises; and
(4) The meals must be provided during, or immediately before or after the employee's workday.

The direct operating costs of a facility are the cost of food and beverages and the cost of labor for personnel performing services at the facility. This test may be applied separately for each of an employer's eating facilities or the costs may be aggregated. Regs. 1.132-7(b).

If an employer can reasonably determine the number of meals received by volunteers who receive food and beverages at a hospital, free or at a discount, the employer may, in determining if the revenue from the facility equals or exceeds the direct operating costs of the facility, disregard all costs and revenues attributable to such meals. The same rule applies to meals that are excludable from income by the recipient employees under I.R.C. 119.

If an employer charges non-employees a greater amount than employees, the employer must disregard all costs and revenues attributable to the meals provided to the non-employees.

If the meal exclusion does not apply, then the employee is taxed on the difference between the fair market value of the meal and the amount the employee paid for the meal. Regs. 1.132-7(c). In the alternative, the employer can use the special valuation rule under Regs. 1.61-21(j).

The exclusion is available to highly compensated employees only if the conditions listed above are satisfied and the facility is available to all employees on substantially the same terms. Regs. 1.132-7(a)(1)(ii).

For years beginning after December 31, 1996, a highly compensated employee is an employee who:

(1) Was a 5 percent owner at any time in the year or the preceding year, or

(2) For the preceding year (a) had compensation from the employer in excess of $80,000, as indexed ($85,000 for 2001), and (b) if the employer so elects, was in the top-paid group of employees for the preceding year. I.R.C. 1431 of the Small Business Job Protection Act, Pub. L. No. 104-188, amending I.R.C. 414(q).

The employer must include leased employees in determining if an eating facility is discriminatory.

Issue to Consider: An organization may have several different eating facilities, some of which may not be available to employees on substantially the same terms. If access to an eating facility is limited to the employee doctors, for example, the hospital should check to see if the nondiscrimination rule is satisfied. The regulations provide that each

dining room or cafeteria must be treated as a separate facility for purposes of the nondiscrimination test, even if it does not have its own kitchen.

A substantial amount could be added to the excess benefits computation of a highly compensated employee if the employer eating facility did not satisfy the nondiscrimination test. If the benefit is not substantiated as compensation, the value is an automatic excess benefit.

C. Qualified Transportation Fringe Benefits

1. Basic Rules

I.R.C. 132(f) provides very specific requirements for excluding the value of certain employer-provided transportation fringe benefits from an employee's gross income. These rules are further discussed in Notice 94-3, 1994-1 C.B. 327, and IRS Publication 15-B. To be excludable, the benefit must be one of the following "qualified transportation fringes:"

(1) Transportation in a commuter highway vehicle;

(2) Transit passes; and

(3) Qualified parking.

If a transportation fringe does not satisfy these requirements, the value of the fringe must be added to the disqualified person's income and will be taken into consideration for purposes of determining excess benefits under I.R.C. 4952. If not substantiated as compensation, the benefit will be an automatic excess benefit.

2. Qualified Transportation Fringes: Parking

Under I.R.C. 132(f)(2), for tax years beginning 2001, up to $180 per month is excludable from the gross income of an employee for qualified parking provided by the employer. For tax years beginning in 1997, the limit was $170 per month.

The general valuation rules of Regs. 1.61-21(b) are used to determine if the amount of a qualified transportation fringe exceeds the excludable amount and to determine the amount includable in income. There are two basic valuation methods.

The value of parking provided by an employer to an employee is based on:

- The cost (including taxes or other added fees) an individual would incur in an arm's-length transaction to obtain parking at the same site.

- If that cost is not ascertainable, then the value of parking is based on the cost an individual would incur in an arm's-length transaction for a space in the same lot or a comparable lot in the same general location under the same or similar circumstances.

NOTE:

(1) A monthly rate may be used to determine a monthly value rather than the daily rate multiplied by the number of days in the month.

(2) If an annual rate is available, the monthly rate may be determined by dividing the annual rate by twelve.

(3) If a space is available for less than a month, the space may be valued according to the daily rate multiplied by the number of days the employee has access to the space.

(4) In no case is it necessary, however, for the monthly value to exceed the monthly rate. These rates may only be used if they are available to the public.

i. Access Rather Than Use

The value of the parking subject to tax under I.R.C. 61 (the amount above the I.R.C. 132 permitted amount) is the right of access on any given day to employer-provided parking, and not the actual use of the parking by the employee.

Example: Greg has unlimited access to qualified parking provided by his employer at no charge to Greg. The fair market value of the parking is $200 per month. The benefit satisfies the requirements of I.R.C. 132(f) so Greg can exclude up to $180 per month from income. In one particular month, Greg used the parking space for only 5 days, because he was away on business travel for 1 week and on a personal vacation for 2 weeks. Because Greg had access to the parking space for the entire month, the amount includable in his gross income and in his excess benefits computation is the amount full monthly fair market value exceeds the statutory limit--$20. If Greg does not substantiate the $20 as compensation, it is an automatic excess benefit.

ii. Definition of “Qualified Parking”

“Qualified parking” is access to parking provided to an employee on or near the employer's business premises or on or near a location from which the employee commutes to work by car pool, commuter highway vehicle, mass transit facilities, transportation provided by any person in the business of transporting persons for

compensation or hire, or by any other means. A car pool means two or more individuals who commute together in a motor vehicle on a regular basis.

The exclusion for qualified parking is not available for parking on or near property used by the employee for residential purposes.

iii. Parking Available Primarily to Customers

Employer-provided parking that is available primarily to customers of the employer, free of charge, will be deemed to have a fair market value of $0. This rule does not apply, however, if an employer maintains "preferential" reserved spaces for employees. A reserved space is "preferential" if it is more favorably located than the spaces available to the employer's customers.

Example: Newco's place of business is situated in a shopping mall. Ample free parking is available primarily to customers in the mall parking lot. Spaces reserved for employees are no closer to the mall than the spaces available to customers. The spaces reserved for employees have a fair market value of $0 because the spaces are not "preferential" reserved spaces.

3. Qualified Transportation Fringes: Commuting in an Employer-Provided Commuter Highway Vehicle

i. In General

Employees may exclude the value of commuting in an employer-provided commuter highway vehicle if certain requirements are satisfied. If these requirements are met, the value of the benefit will also be disregarded for purposes of I.R.C. 4958.

ii. Definition of commuter vehicle

A "commuter highway vehicle" is any highway vehicle that:

(1) Has a seating capacity of at least six adults (excluding the driver); and

(2) At least 80% of the vehicle's mileage use must be reasonably expected to be—

For transporting employees in connection with travel between their residences and their place of employment; and

On trips when the number of employees transported for commuting is, on average, at least one-half of the adult seating capacity of the vehicle (excluding the driver).

Commuter highway vehicles (or "vanpools") can be operated by the employer, by a third party for the employer, or by the employees.

The maximum value of an employee's excludable transportation was $65 per month in 1997 through 2001; it rises to $100 in 2002; and will increase with inflation each year thereafter. Notice 94-3, 1994-1 C.B. 327, 330, instructs that any of four valuation methods may be used. They are Regs 1.61-2(b), 1.61-2(d), 1.61-2(e), and 1.61-2(f). The monthly maximum is a combined total for commuter vans and transit passes.

4. Qualified Transportation Fringes: Transit Passes

The value of transit passes provided by an employer to employee is also excluded from income and disregarded from I.R.C. 4958 if certain conditions are met. A "transit pass" is any pass, token, farecard, voucher, or similar item entitling a person to transportation (or transportation at a reduced price):

(1) On mass transit facilities (whether or not publicly owned); or

(2) Provided by any person in the business of transporting persons for compensation or hire in a commuter highway vehicle.

As noted above, the maximum excludable value of the pass is the combined value of employer provided commuter vehicle travel and the value of the transit pass.

5. Definition of Employee

Employers can provide qualified transportation fringes only to "employees" within the meaning of Regs 1.132-1(b)(2)(i). This definition includes common law employees and other statutory employees, such as officers of corporations.

Self-employed individuals, who are employees within the meaning of I.R.C. 401(c)(1), are not employees for purposes of I.R.C. 132(f). Therefore, partners, 2-percent shareholders of S corporations, sole proprietors, and other independent contractors are not employees for purposes of I.R.C. 132(f). An individual who is both a 2-percent shareholder of an S corporation and an officer of that S corporation is not considered an employee for purposes of I.R.C. 132(f).

However, an independent contractor may exclude as a *de minimis* fringe benefit a public transit pass provided to the independent contractor if the value of the pass does not exceed $21 in any month. If the value does exceed $21, the entire value is includable in income, and is an excess benefit for a disqualified person if compensation is unreasonable or if there was no contemporaneous substantiation. An independent contractor may only

exclude the value of parking if the parking qualifies as a *de minimis* fringe benefit; the parking cannot be excluded as a working condition fringe benefit. Regs. 1.132-1(b)(2).

6. Cash Reimbursements

Cash reimbursements (but not cash advances) by an employer to an employee for qualified parking, transit passes, and transportation in a commuter highway vehicle are also excludable from income and disregarded under I.R.C. 4958. This treatment is only available if the employer establishes a bona fide reimbursement arrangement to ensure employees have incurred the expenses.

However, cash reimbursements for transit passes are only excludable if a voucher or similar item that may be exchanged for a transit pass is not readily available to the employer.

For example, if the employer cannot obtain a voucher on terms no less favorable than those to individual employees and without incurring a significant administrative cost).

D. Qualified Employee Discounts

An employee who purchases, at a discount, the qualified goods or services of the employer may exclude the discount from income if certain conditions are met. I.R.C. 132(c); Regs. 1.132-3. If they are not satisfied, the discount's value is included in the employee's compensation for purposes of I.R.C. 4958. I.R.C. 132(c) requires:

(1) The employee must perform substantial services in the same line of business in which the discounted property or services are sold.

(2) The property discounted must be offered for sale to customers in the ordinary course of the employer's line of business.

The line of business limitation is not satisfied if the employer's property or services are sold primarily to employees, rather than to customers.

Qualified property does not include (a) real property and (b) personal property (whether tangible or intangible) of a kind commonly held for investment.

(3) The discount is limited.

For <u>services</u> sold to an employee at a discount, the maximum discount permitted is 20% of the price the services are being offered by the employer to customers.

> For property sold to an employee at a discount, the maximum permitted is the employer's "gross profit percentage" multiplied by the sales price of the property to customers.

The gross profit percentage is the excess of the aggregate sales price of the property sold by the employer to customers and employees over the employer's aggregate cost of the property, then divided by the aggregate sales price. The aggregate values have to be used because goods and services are often sold at a variety of prices. The following example is from the regulations.

If the aggregate sales price of property in an employer's line of business for the prior taxable year was $800,000 and the aggregate cost of the property for the year was $600,000, the gross profit percentage would be 25 percent ($800,000 minus $600,000, then divided by $800,000).

The gross profit percentage is then applied to the price the property is being offered for sale to customers to determine the exact dollar amount of the qualified employee discount. The gross profit percentage must be calculated separately for each line of business. The regulations provide special rules for determining the sales price to customers.

The qualified employee discount exclusion applies only to current employees, retired employees, their spouses and certain others. Independent contractors are not eligible for the exclusion. Regs. 1.132-1(b)(1).

Under special nondiscrimination rules, the qualified employee discount exclusion applies to highly compensated employees only if the benefit is nondiscriminatory. If the nondiscrimination rules are not met, the exclusion is nevertheless available to non-highly compensated employees. Regs 1.132-8.

E. Qualified Moving Expense Reimbursements

I.R.C. 132(g) provides "qualified moving expense reimbursements" provided by employers after December 31, 1993, will be excludable from an employee's income if certain conditions are satisfied. *See* Section 13213(d) of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66. *See also* IRS Publication 521 (Moving Expenses) for more detailed rules. To the extent the requirements are met, the reimbursements are disregarded for I.R.C. 4958 purposes. Organizations sometimes provide substantial moving benefits to disqualified persons.

1. Basic Rule

A "qualified moving expense reimbursement" is any amount received (directly or indirectly) by an individual from an employer as payment for (or a reimbursement of) expenses that would be deductible as moving expenses under I.R.C. 217 if directly paid or incurred by the individual.

2. Changes to I.R.C. 217

After December 31, 1993, deductible moving expenses are limited to the reasonable costs of (1) moving household goods and personal effects from the former residence to the new residence and (2) traveling (including lodging in the period of travel) from the former residence to the new place of residence. Deductions are not permitted for meals, real estate expenses, premoving house-hunting expenses, and temporary living expenses. Also, the mileage limit to qualify for the deduction was raised from 35 to 50 miles.

If the employer advances or reimburses an employee for expenses made in connection with the employee's move and the advance or reimbursement exceeds the "qualified moving expense reimbursement" permitted by I.R.C. 132(g), the excess must be included in the employee's gross income. It will also be considered wages for employment tax purposes and must be included in the excess benefit computation subject to the substantiation of compensation rules.

3. Use of Relocation Companies

Employers often use third party relocation companies to handle the sales of employees' homes. The payment of a real estate commission by a relocation company has recently been considered. Since commissions are no longer deductible under I.R.C. 217, any payment of the commission by the employer (or by the relocation company on the employer's behalf) would be income to the employee <u>if</u> the employee was legally obligated to pay the commission.

Conversely, if the employee was <u>not</u> legally obligated to pay the real estate commission, due to complicated use of exclusionary clauses in listing agreements and "separate" sales (i.e., one from the employee to the relocation company and another from the company to the independent buyer), the Service has taken the position that there is no income or wages to the employee.

This complicated issue requires careful analysis of the facts and circumstances, including whether the exclusionary clause effectively insulates the employee from any legal obligation to pay the commission. If you have any questions please contact one of the authors of this article.

F. Special Rule for Athletic Facilities

An employee is not taxed on the value of the use of an athletic facility operated by the employer and located on the employer's premises, provided substantially all the use of the facility is by employees, their spouses and their dependent children. I.R.C. 132(j)(4); Regs. 1.132-1(b)(3).

This exclusion applies to the use of a gym, pool, golf course, tennis course or other athletic facility. It does not apply to any facility if access to the facility is made available to the public through the sale of memberships, the rental of the facility, or a similar arrangement. The exclusion does not apply to any athletic facility for residential use, such as a resort with accompanying athletic facilities.

No nondiscrimination rules must be met for the exclusion to apply. Regs. 1.132-1(e)(5).

Issues to consider: The substantial use restriction may prevent the athletic facility exclusion from applying to employees of hospitals, particularly university hospitals. For example, if substantially all athletic facility use is by students, the exclusion may not apply to faculty and other employees.

Part 4 – Fringe Benefits Subject to Other Statutory Exclusions

Only I.R.C. 132 fringe benefits are excluded from income for income tax purposes and disregarded for purposes of I.R.C. 4958. There are fringe benefits excluded from income under sections of the Code other than I.R.C. 132. These fringe benefits are taken into consideration for purposes of I.R.C. 4958. An I.R.C. 4958 analysis requires they be included in the recipient's compensation for purposes of determining if these and other benefits are excessive.

However, these fringe benefits are not subject to I.R.C. 4958(c)(1) and I.R.C. 53.4958-4T(c) of the regulations. So the organization providing the benefits does not have to contemporaneously substantiate its intent to treat the amount as compensation. Contemporaneous substantiation is more fully discussed in Section B relating to the rebuttable presumption.

Regs. 53.4958-4T(c)(2) provides an organization is not required to indicate its intent to provide an economic benefit as compensation for services if the economic benefit is excluded from the disqualified person's gross income for income tax purposes by the provisions of chapter 1 of Subtitle A.

Examples of these benefits include, but are not limited to employer-provided health benefits and contributions to a qualified pension, profit-sharing or stock bonus plan under

I.R.C. 401(a), and any benefits described in I.R.C. 127 and I.R.C. 137. Except for disregarded economic benefits (I.R.C. 132 benefits), all compensatory benefits an organization provided in exchange for performance of services are taken into account in determining the reasonableness of a person's compensation for purposes of I.R.C. 4958.

We will discuss below several statutory exclusions most likely to apply to the disqualified persons of exempt organizations.

A. Employer-Provided Meals Under I.R.C. 119

For employer-provided meals to be excludable from an employee's gross income under I.R.C. 119, three conditions must be satisfied:

- The meals must be provided in kind; if an employee has an option to receive additional compensation in lieu of the meals, the value of the meals is not excludable;
- The meals must be provided for the convenience of the employer; and
- The meals must be provided on the employer's business premises. (Because of the more favorable I.R.C. 119 treatment for employer-provided meals, the agent may consider treating the Regs. 1.132-7 employer-provided meals as I.R.C. 119 meals, in the absence of evidence to the contrary.)

B. Employer-Provided Lodging Under I.R.C. 119

For employer-provided lodging to be excludable from an employee's gross income under I.R.C. 119, four conditions must be satisfied:

- The lodging must be provided in kind; if an employee has an option to receive additional compensation in lieu of actual lodging, the value of the lodging is not excludable;
- The lodging must be provided for the convenience of the employer;
- The lodging must be on the employer's business premises; and
- The lodging must be a condition of the employee's employment (i.e., the employee must be compelled or required to accept the lodging to be able to properly perform the duties of the job).

C. Special Rules for Educational Institutions — I.R.C. 119(d)

For lodging not meeting the rule of I.R.C. 119(a), which excludes the full value of the lodging from an employee's gross income, the special rule of I.R.C. 119(d) may apply.

The value of qualified campus lodging furnished to an employee of an educational institution is not included in the employee's gross income except to the extent the employee has not paid rent equal to or in excess of the safe harbor valuation rule of I.R.C. 119(d)(2).

Qualified campus lodging must be located on, or in the proximity of, the educational institution's campus. It may be provided to any employee of the educational institution, including non-faculty employees. The benefit extends to the employee's spouse and dependents.

The rent an employee pays must at least equal the *lesser* of (i) 5% of the appraised value of the lodging, or (ii) the average of rentals paid (other than by employees or students) to the educational institution for comparable housing during the calendar year. A qualified independent appraiser must determine fair market value on an annualized basis. Although a new appraisal is not required every year, the appraisal must be reviewed annually.

The use of the above formula in connection with I.R.C. 4958 may be illustrated by the following example:

Mr. Wisdom, a professor at Paradise University, rents a home from the University that is qualified campus lodging. The residence is appraised at $200,000. Five percent of $200,000 is $10,000 per year. The average rent paid by persons other than employees or students is $15,000 and $15,000 is the fair rental value of Professor Wisdom's house. If Professor Wisdom pays $11,000 rent, the rental value of the house is excludable from income, but the $4,000 below market rental benefit is included in his I.R.C. 4958 excess benefit computation.

If Professor Wisdom paid only $8,000 rent, then $2,000 ($10,000 less $8,000) would be includable in his income. Under I.R.C. 4958, the full amount of the below-market rental benefit must be taken into account. $15,000 fair rental value less the $10,000 (5% of appraised value) is still excluded from income under I.R.C. 119(d), and that amount is included in the reasonable compensation calculation even if it is not substantiated as compensation. The $2,000 that is included in income is included in the excess benefit computation if substantiated as compensation; if not so substantiated, the $2,000 is an automatic excess benefit.

D. Tuition Reduction Plan Under I.R.C. 117(d)

If a tuition reduction plan is not a "qualified tuition reduction" within the meaning of 117(d), then the benefit is taxable. For example, it may be determined that a program discriminates in favor of highly compensated employees within the meaning of I.R.C. 117(d)(3) and 414(q).

Nonetheless, a qualified tuition reduction provided to employees who are not highly compensated employees within the meaning of I.R.C. 414(q) is excluded from income notwithstanding that the plan under which the benefits are offered is discriminatory within the meaning of I.R.C. 117(d)(3).

Highly compensated employees will be taxed on the value of the benefit unless the plan is nondiscriminatory.

Except as provided in I.R.C. 117(d)(5) for teaching and research assistants, the term "qualified tuition reduction" applies only to education below the graduate level. A plan that provides graduate tuition benefits to faculty, staff, and their families is not a qualified tuition reduction plan.

All tuition reductions are added to the calculation of reasonable benefits under I.R.C. 4958.

E. Examples of other I.R.C. provisions excluding specific fringe benefits are:

I.R.C. 104(a)(1)	Amounts received under worker's compensation statutes
I.R.C. 105	Amounts received under accident and health plans
I.R.C. 106	Contributions by employer to accident and health plans
I.R.C. 125	Cafeteria plans

<u>Part 5 – Treatment of Fringe Benefits Not Excludable from Income</u>

I.R.C. 4958 treats fringe benefits in three different ways.

(1) Benefits excluded from income under I.R.C. 132 are disregarded.

(2) Benefits excluded from income under other Code sections are included in the calculation of reasonable compensation whether or not they are substantiated as compensation. If compensation is found not to be reasonable, there will be taxable excess benefit.

(3) Benefits included in income. If substantiated as compensation the benefit will be included in the calculation of reasonable compensation. If compensation is

found not to be reasonable, there will be taxable excess benefit. If not substantiated, the benefit is an excess benefit and is taxable.

Examples of fringe benefits not covered by any statutory exclusion, include:

(1) Employer-provided accounting and financial counseling
(2) Interest free loans
(3) Housing assistance payments
(4) Expense paid vacations or free use of employer-provided vacation homes
(5) Employer provided vacation travel
(6) Clothing allowances for personal clothing
(7) Employer provided pleasure boats
(8) Employer payments of mortgages on employee's residence
(9) Employer provided interest free or below-market-rate loans.

The key to compliance with I.R.C. 4958 is to follow the substantiation rules. An exempt organization substantiates a fringe benefit by clearly indicating its intent to treat the benefit as compensation when the benefit is paid. This is done by providing written substantiation that is contemporaneous with the transfer of the fringe benefits under consideration. This substantiation may take one of several forms:

(1) A signed written employment contract; or

(2) The organization reports the benefit as compensation on an original Form W-2, Form 1099, or Form 990, or on an amended form filed before the start of an IRS examination; or

(3) The disqualified person reports the benefit as income on the person's original Form 1040 or on an amended form filed before the start of an IRS examination.

(4) In the case of fringe benefits that are claimed to be excludable from income, contemporaneous substantiation includes any written evidence that the benefits were intended as excludable compensation (for example: a contract; board minutes; or an employee handbook; or an opinion by a benefits company, an attorney, a C.P.A., or an enrolled agent that the benefits are excludable from income.)

There are three ways these substantiation rules can become necessary.

First, if the fringe benefit is a type not described in an exclusion statute.

Second, if all or part of the value of a statutory fringe benefits (either under I.R.C. 132 or other income exclusion provisions) fails to comply with the requirements of the Code. For example, the extent an employer-provided automobile exceeds the I.R.C. 132 exclusion limitations, or the extent an I.R.C. 127 dependent care allowance exceeds the statutory maximum.

Third, if the benefit completely fails to comply with the requirements of I.R.C. 132 or the other exclusion provisions. For example, if a benefit failed a nondiscrimination requirement of one of these provisions, or if a benefit was not covered at all by one of these provisions. In such situations, the entire value of the benefit automatically becomes subject to the I.R.C. 4958 tax if the benefit is not substantiated.

Part 6 – Valuation of Fringe Benefits

If a fringe benefit is not excluded from gross income or only partially excluded, it must be valued. The employee is taxed on the amount the fair market value (FMV) of the fringe benefit exceeds the sum of:

(1) The amount paid for the benefit by or for the employee, and

(2) The amount, if any, specifically excluded from gross income by another section of the I.R.C. Regs 1.61-21(b)(1).

This remaining amount is included in compensation for I.R.C. 4958 purposes and is subject to the reasonable compensation analysis.

A. General Rule — Fair Market Value

The general rule of valuation is to use fair market value (FMV), the amount an individual would have to pay for the particular fringe benefit in an arm's-length transaction to buy or lease the benefit. The effect of any special relationship that may exist between the employer and the employee must be disregarded in determining FMV. Further, the employee's subjective perception of the value of a fringe benefit and the cost incurred by the employer are not relevant to the determination.

The regulations, however, provide special valuation rules for some commonly-provided fringe benefits, such as the use of employer-provided vehicles and airplanes. If an employer uses a special valuation rule, the special value is treated as the FMV of the benefit for income tax, employment tax and other reporting purposes. Regs 1.61-21(c)(2).

B. Rules for Valuing Use of Employer-Provided Automobiles

There are special valuation rules an employer may use to value an employee's use of an employer-provided automobile. (These valuation rules are discussed in Part 3A - Working Condition Fringe Benefits.) Generally, an employee's use of an employer-provided vehicle for the employer's business purposes will be excluded from the employee's income as a working condition fringe benefit if the use is properly documented.

Personal use, such as commuting, is taxable to the employee. If a special valuation rule is not properly applied or if it is used to value a fringe benefit by a person not entitled to use the rule, FMV must be determined under the general valuation rules. Regs 1.61-21(c)(5).

Part 7 – Employment Tax Treatment of Fringe Benefits

A. General Rule

The rules concerning the employment tax implications of fringe benefits have no application to the I.R.C. 4958 analysis. The rules are provided here only to provide a more complete understanding of the taxation of fringe benefits. For a more complete discussion, see IRS Publication 15, Circular E (Employers' Tax Guide).

If a fringe benefit is excludable from the employee's gross income, then its value is not added to the employee's wages and there are no employment tax consequences. On the other hand, if the benefit is not excludable (or is only partially excludable), its value must be reported as wages in Box 1 of the employee's Form W-2 and the employer generally must withhold income taxes and the employee's share of FICA, besides paying its share of FICA and FUTA.

The employment tax provisions exclude a benefit from wages if at the time the benefit was provided it was reasonable to believe the employee was able to exclude the benefit from income under I.R.C. 132.

The employer, at a minimum, must have ascertained the applicable law and applied it to the particular facts. In other words, the reasonable belief asserted must be based on a reasoned judgment made at or before the time the benefit was provided. The fact an employer's competitors treat certain benefits as excludable is insufficient to support the employer's assertion of a reasonable belief.

Employers are subject to penalties for failing to report correctly employee compensation, including fringe benefits. These penalties include a 100% penalty for the

employer's failure to collect and pay the employee's share of FICA taxes attributable to taxable fringe benefits.

B. Special Rule for Non-Cash Fringe Benefits

Special reporting and withholding rules apply to an employer's provision of non-cash fringe benefits, such as vehicles:

- An employer may elect to treat the benefits as paid on a pay period, semiannual or annual basis, as long as the benefits are treated as paid no less frequently than annually.

- An employer may withhold income taxes at the flat 28% supplemental wage-withholding rate.

- An employer may treat benefits provided in the last two months of the employer's tax year (e.g., November and December) as paid in the following tax year.

- An employer may elect not to withhold income taxes on the value of the personal use of a vehicle, as long as the employer so notifies the employee and includes the taxable amount on the employee's Form W-2.

IRS Announcement 85-113, 1985-31 I.R.B. 31.

F. Conclusion

I.R.C. 4958 imposes excise taxes on top officials of I.R.C. 501(c)(3) and I.R.C. 501(c)(4) organizations who receive excessive economic benefits from their organizations. Also, I.R.C. 4958 imposes excise taxes on managers who knowingly participate in the transfer of these excessive economic benefits. However, top officials of these organizations who would be liable for these taxes may avoid them by making proper and timely restitution to the organization. Recently, the Treasury Department issued temporary regulations implementing I.R.C. 4958. A thorough understanding of these regulations is key to the ability of the Service to fairly and accurately apply I.R.C. 4958.

Appendices

Appendix 1 – I.R.C. 4958 in Steps
Appendix 2 – Rebuttable Presumption Checklist – Compensation
Appendix 3 – Rebuttable Presumption Checklist – Property

APPENDIX 1

I.R.C. 4958 IN STEPS

Step 1 – Determine if the organization is an *applicable tax-exempt organization* (*ATEO*).

- Include organizations that were *ATEOs* at any time in 5-year Lookback Period.
- Eliminate private foundations.
- Eliminate governmental entities. Regs. 53.4958-2T(a)(1).
- Eliminate organizations whose exemption has been revoked for reasons other than inurement or private benefit. Regs. 53.4958-2T(a)(4).

If organization is not an ATEO, IRC 4958 does not apply.

Step 2 – Determine if *ATEO* is a church.

- For churches, follow the procedures of IRC 7611. Regs. 53.4958-8T(b).

Step 3 – Identify the *disqualified persons* (*DPs*).

- Identify persons who are:

1) Automatically not *DPs*. Regs. 53.4958-3T(d).

If there are no DPs, IRC 4958 does not apply.

2) Automatically *DPs*. Regs. 53.4958-3T(c).

3) Family members of a *DP*. Regs. 53.4958-3T(b)(1).

4) Entities controlled by a *DP*. Regs. 53.4958-3T(b)(2).

5) Determine if there are facts and circumstances tending to show that the person:

Has substantial influence over the affairs of the *ATEO*. Regs. 53.4958-3T(e)(2).

If there are no DPs, IRC 4958 does not apply.

Step 4 – Determine if DPs have engaged in *excess benefit transactions*.

- Review all significant transactions between *DPs* and *ATEO*.

- Determine when each transaction *occurred*. Regs. 53.4958-1T(e).

- Determine whether each transaction *occurred* on or after September 14, 1995. Regs. 53.4958-1T(f).

  Eliminate transactions that *occurred* under a written contract that was binding on September 13, 1995 and at all times thereafter before the transaction *occurred*.

  Do not eliminate transactions that *occurred* under a binding written contract if the contract was *materially changed* after September 13, 1995.

- Determine when the *period of limitations* ends for each *excess benefit transaction*. Regs. 53.4958-1T(e)(3).

  Eliminate transactions that *occurred* after the period of limitations ended.

- ***Eliminate*** portions of transactions that involve:

  Fixed payments made under an *initial contract*. Regs. 58.4958-4T(a)(3).

  Nontaxable fringe benefits excludable under IRC 132. Regs. 53.4958-4T(a)(4)(i).

  Other disregarded benefits. Regs. 53.4958-4T(a)(4)(ii) to (v).

  Expense reimbursements paid under an "accountable plan" under Regs. 1.62-2(c)(2).

- Test the remaining transactions to determine if the *ATEO* clearly indicated its intent to treat the benefits as compensation for services. Regs. 53.4958-4T(c).

  If not, the benefits are treated as excess benefits.

- Determine the value of benefits ATEO provided to DP and the value of the consideration received from the DP. Regs. 53.4958-4T(b)(1).

  If the value of economic benefits ATEO provided to DP exceeds value of consideration received from DP, DP has received an excess benefit.

  If there is no excess benefit, IRC 4958 does not apply.

Step 5 – You have now identified the excess benefit transactions. Has the Rebuttable Presumption been established by the ATEO?

- If the Rebuttable Presumption has been established**:**

  Has the Service developed sufficient contrary evidence to rebut the comparability data? Regs. 53.4958-6T(b)

  If the Service cannot rebut the presumption, the transaction is not an excess benefit transaction.

- If the Rebuttable Presumption has not been established:

  Since the Rebuttable Presumption is not a requirement, analyze the transaction to determine if the DP received an excess benefit.

Step 6 – Contact EO Technical to determine if a request for technical advice should be submitted.

You can call either:

Larry Brauer	202-283-9457
Toussaint Tyson	202-283-8977
Len Henzke	202-283-8865
Debra Kawecki	202-283-9486
Chuck Barrett	202-283-8944

APPENDIX 2

REBUTTABLE PRESUMPTION CHECKLIST
COMPENSATION

(See text for definitions of terms in *italics*.)

1. *Applicable tax-exempt organization*: _____

2. *Disqualified person*:

   Name: _____

   Title / Position Description: _____

3. Terms of compensation arrangement:

   Salary: _____

   Bonus: _____

   Deferred compensation: _____

   Fringe benefits (excluding IRC 132 fringes and expense reimbursements under an accountable plan):
   _____
   _____

   Liability insurance premiums: _____

   Foregone interest on loans: _____

   Other: _____

4. Name of *authorized body*: _____

5. Date *authorized body* approved compensation arrangement: _____

6. Members of a*uthorized body* on date of approval:
   A. _____
   B. _____
   C. _____
   D. _____
   E. _____

7. Titles / Positions in *applicable tax-exempt organization*:
   A. _____
   B. _____
   C. _____
   D. _____
   E. _____

8. Background (education, experience, etc.):
   A. _____
   B. _____
   C. _____
   D. _____
   E. _____

9. *Conflict of interest* as to compensation arrangement:
   A. _____
   B. _____
   C. _____
   D. _____
   E. _____

10. Comparable Data

- Compensation paid by similar organizations for functionally comparable positions: _____
  _____
- Availability of similar services in geographic area of *applicable tax-exempt organization*: _____
  _____
- Current compensation surveys compiled by independent firms: _____
  _____
  _____
- Actual written offers from similar institutions: _____
  _____
- If *applicable tax-exempt organization* is a *small organization*, compensation data paid by 3 comparable organizations in similar communities for similar services:
  1. _____
  2. _____
  3. _____

11. Documentation

Description of records: _____

Date records were prepared: _____

Date records were approved by *authorized body*: _____

Per records:

- Terms of transaction approved: _____
  _____
- Date reviewed and approved by *authorized body* as reasonable, accurate and complete: _____
- Members of *authorized body* present during debate:
  A. _____
  B. _____
  C. _____
  D. _____
  E. _____
- Members of *authorized body* who voted on transaction:
  A. _____
  B. _____
  C. _____
  D. _____
  E. _____
- Description of comparability data obtained and relied on by *authorized body*:
  _____
  _____
- Description of how comparability data was obtained:
  _____
- Description of any actions taken as to consideration of transaction by member of *authorized body* who had a *conflict of interest*: _____
  _____
- If value determined differs from comparability data, basis for determination:
  _____
  _____

12. For a non-fixed payment subject to a cap:

    - Date authorized body obtained comparability data that a fixed payment would be reasonable compensation: _____

    - Amount of such fixed payment: _____

    - Maximum amount payable under contract (both fixed and non-fixed payments): _____

APPENDIX 3

REBUTTABLE PRESUMPTION CHECKLIST
PROPERTY

(See text for definitions of terms in *italics*.)

1. *Applicable tax-exempt organization*: _____

2. *Disqualified person*:

   Name: _____

   Title / Position Description: _____

3. Property to be transferred or used:

   Description: _____

   Location: _____

4. Name of *authorized body:* _____

5. Date *authorized body* approved property transfer:
   _____

   Members of a*uthorized body* on date of approval:
   A. _____
   B. _____
   C. _____
   D. _____
   E. _____

7. Titles / Positions in *applicable tax-exempt organization*:
   A. _____
   B. _____
   C. _____
   D. _____
   E. _____

8. Background (education, experience, etc.):
   A. _____
   B. _____
   C. _____
   D. _____
   E. _____

9. *Conflict of interest* as to property transfer:
   A. _____
   B. _____
   C. _____
   D. _____
   E. _____

10. Comparable Data – Appraisals

- Appraiser(s) name and address:

_____
_____

- Appraiser(s) qualifications:

_____
_____

- Date(s) of appraisal(s):

_____
_____

- Fair market value per appraisal(s):

_____
_____

- Appraisal method(s) used (e.g., sales comparison, income analysis, replacement cost, etc.):

_____
_____

11. Comparable Data – Offers received from open and competitive bidding:

_____
_____

12. Documentation

Description of records: _____

Date records were prepared: _____

Date records were approved by *authorized body*: _____

Per records:

- Terms of transaction approved: _____
  _____
- Date reviewed and approved by *authorized body* as reasonable, accurate and complete: _____
- Members of *authorized body* present during debate:
  A. _____
  B. _____
  C. _____
  D. _____
  E. _____
- Members of *authorized body* who voted on transaction:
  A. _____
  B. _____
  C. _____
  D. _____
  E. _____
- Description of comparability data obtained and relied on by *authorized body*:
  _____
  _____
- Description of how comparability data was obtained: _____
  _____
- Description of any actions taken as to consideration of transaction by member of *authorized body* who had a *conflict of interest*: _____
  _____
- If value determined differs from comparability data, basis for determination:
  _____
  _____