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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 53

REG-111257-05

RIN 1545-BE37

Standards for Recognition of Tax-Exempt Status if Private Benefit Exists or if an Applicable Tax-Exempt Organization has Engaged in Excess Benefit Transaction(s)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that clarify the substantive requirements for tax exemption under section 501(c)(3) of the Internal Revenue Code (Code). This document also contains provisions that clarify the relationship between the substantive requirements for tax exemption under section 501(c)(3) and the imposition of section 4958 excise taxes.

DATES: Written comments and requests for a public hearing must be received by December 8, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-111257-05), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-111257-05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically

via the IRS Internet site at www.irs.gov/regs or the Federal eRulemaking Portal at www.regulations.gov (IRS-REG-111257-05). A public hearing may be scheduled if requested.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Galina Kolomietz, (202) 622-4441; Concerning submission of comments and requests for a public hearing, Richard Hurst, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION

Background

A. Section 501(c)(3) and the Regulations Thereunder

To be described in section 501(c)(3), an organization must be organized and operated exclusively for religious, charitable, scientific, or educational purposes. In addition, no part of the net earnings of the organization may inure to the benefit of any private shareholder or individual, no substantial part of the organization's activities may include attempts to influence legislation, and the organization may not intervene in political campaigns.

Existing regulations under section 501(c)(3) were adopted in substantially their present form in 1959. In explaining and clarifying the statutory requirements, these regulations provide that, to be described in section 501(c)(3), an organization must be both organized and operated for exempt purposes. An organization is not operated exclusively for exempt purposes and, thus, is not described in section 501(c)(3), if any of its net earnings inure to the

benefit of a private shareholder or individual. §1.501(c)(3)-1(c)(2). The regulations define private shareholder or individual as referring to persons having a personal and private interest in the activities of the organization. §1.501(a)-1(c).

In addition, an organization is not organized or operated for one or more of the exempt purposes enumerated in §1.501(c)(3)-1(d)(1)(i) and, thus, is not described in section 501(c)(3), if it is organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such interests. §1.501(c)(3)-1(d)(1)(ii).

These proposed regulations amend the regulations under section 501(c)(3), adding several examples to illustrate the requirement in §1.501(c)(3)-1(d)(1)(ii) that an organization serve a public rather than a private interest. The examples illustrate that prohibited private benefits may involve non-economic benefits as well as economic benefits. In addition, prohibited private benefit may arise regardless of whether payments made to private interests are reasonable or excessive. The examples reflect current law.

B. Section 4958 and the Regulations Thereunder

Section 4958 was added to the Code by the Taxpayer Bill of Rights 2, Public Law 104-168 (110 Stat. 1452; July 30, 1996). Section 4958 imposes certain excise taxes on transactions that provide excess economic benefits to disqualified persons with respect to public charities and social welfare

organizations described in sections 501(c)(3) and 501(c)(4), respectively. These organizations are collectively referred to as applicable tax-exempt organizations. Section 4958(e). An excess benefit is the amount by which the value of an economic benefit provided by an applicable tax-exempt organization directly or indirectly to or for the use of a disqualified person exceeds the value of the consideration (including the performance of services) received for providing such benefit. §53.4958-1(b). A disqualified person is defined as a person who is in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization. Section 4958(f)(1). Section 4958(a) imposes the liability for excise taxes on disqualified persons who receive an excess benefit from, and on certain organization managers who knowingly participate in, an excess benefit transaction. Section 4958 imposes no corresponding sanctions on exempt organizations. The section 4958 excise taxes generally apply to excess benefit transactions occurring on or after September 14, 1995.

On August 4, 1998, a notice of proposed rulemaking (REG-246256-96) clarifying certain definitions and rules contained in section 4958 was published in the **Federal Register** (63 FR 41486). Those 1998 proposed regulations were revised in response to written and oral comments and replaced by temporary and proposed regulations on January 10, 2001 (TD 8920, 66 FR 2144, and REG-246256-96, 66 FR 2173). Final regulations under section 4958 were published on January 23, 2002 (TD 8978, 67 FR 3076).

C. History of the Relationship Between Section 4958 Taxes and Tax-exempt Status

Section 501(c)(3) and the longstanding regulations thereunder establish certain tests that an organization must meet to qualify for tax-exempt status. §1.501(c)(3)-1(a)(1). Section 4958, by its terms, does not address the tax-exempt status of applicable tax-exempt organizations, but instead imposes excise tax liability on disqualified persons and certain organization managers.

In the 1996 House Report on section 4958, Congress briefly addressed the relationship between section 4958 and tax-exempt status. Specifically, the Report stated that these “intermediate sanctions for excess benefit transactions may be imposed by the IRS in lieu of (or in addition to) revocation of the organization’s tax-exempt status.” H. Rep. No. 104-506, 104th Cong., 2d Sess., at 59 (1996) (emphasis added). The Report also stated, in a footnote, that, in general, revocation of tax-exempt status, with or without the imposition of excise taxes, would occur only if an organization no longer operates as a charitable organization. H. Rep. No. 104-506, 104th Cong., 2d Sess., at 59, note 15.

In keeping with the differences between section 501(c)(3) and section 4958, the Treasury Department and the IRS consistently have taken the position that the imposition of excise taxes under section 4958 does not foreclose revocation of tax-exempt status in appropriate cases. The 1998 proposed regulations under section 4958 stated that “[t]he excise taxes imposed by section 4958 do not affect the substantive statutory standards for tax exemption under section 501(c)(3) or (4).” Proposed §53.4958-7(a), (63 FR 41,505). Both the 2001 temporary and the 2002 final regulations stated that--

Section 4958 does not affect the substantive standards for tax exemption under section 501(c)(3) or (4), including the requirements that the organization be organized and operated exclusively for exempt purposes, and that no part of its net earnings inure to the benefit of any private shareholder or individual. Thus, regardless of whether a particular transaction is subject to excise taxes under section 4958, existing principles and rules may be implicated, such as the limitation on private benefit. (26 CFR 53.4958-8(a)).

The preamble to the 1998 proposed regulations under section 4958 stated that the IRS will exercise its administrative discretion in enforcing the requirements of sections 4958, 501(c)(3), and 501(c)(4). The preamble to the 1998 proposed regulations listed the following four factors the IRS will consider in determining whether an applicable tax-exempt organization described in section 501(c)(3) continues to be described in section 501(c)(3) in cases in which section 4958 excise taxes are also imposed: (1) whether the organization has been involved in repeated excess benefit transactions; (2) the size and the scope of the excess benefit transactions; (3) whether, after concluding that it has been party to an excess benefit transaction, the organization has implemented safeguards to prevent future recurrences; and (4) whether there was compliance with other applicable laws. (63 FR 41,488 through 41,489).

The preamble to the 2001 temporary regulations stated that the IRS intends to publish guidance regarding the factors it will consider as it gains more

experience in administering section 4958. The preamble to the 2002 final regulations stated that, until such guidance is published, the IRS will consider all relevant facts and circumstances in the administration of section 4958 cases. These proposed regulations amend the regulations under section 501(c)(3) to provide guidance on certain factors that the IRS will consider in determining whether an applicable tax-exempt organization described in section 501(c)(3) that engages in one or more excess benefit transactions continues to be described in section 501(c)(3).

D. Section 4958 and Application for Recognition of Tax-exempt Status Under Section 501(c)(3)

Section 4958 and the regulations thereunder do not apply to organizations that are not applicable tax-exempt organizations as defined therein. These proposed regulations amend the regulations under section 4958 to clarify that the IRS has discretion to refuse to issue a ruling recognizing exemption under section 501(c)(3) to any applicant whose purpose or activities violate any provision of section 501(c)(3), including the inurement prohibition and the limitation on private benefit, even though such violation could serve as grounds for imposing section 4958 excise taxes if the applicant's tax-exempt status were recognized.

E. Proposed Effective Date

These regulations are proposed to be applicable on the date of publication in the **Federal Register** of a Treasury Decision adopting them as final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this notice of proposed rulemaking, and because this notice of proposed rulemaking does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing may be scheduled if requested in writing by a person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Galina Kolomietz and Phyllis Haney, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 53

Excise taxes, Foundations, Investments, Lobbying, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 53 are proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.501(c)(3)-1, paragraph §1.501(c)(3)-1(d)(1)(iii) is redesignated as the entry for §1.501(c)(3)-1(d)(1)(iv).

Par. 3. In §1.501(c)(3)-1, paragraphs (d)(1)(iii) and (g) are added to read as follows:

§1.501(c)(3)-(1) Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

* * * * *

(d) * * *

(1) * * *

(iii) Examples. The following examples illustrate the requirement of paragraph (d)(1)(ii) of this section that an organization serve a public rather than a private interest:

Example 1. (i) O is an educational organization the purpose of which is to study history and immigration. The focus of O's historical studies is the genealogy of one family, tracing the descent of its present members. O actively solicits for membership only individuals who are members of that one family. O's research is directed toward publishing a history of that family that will document the pedigrees of family members. A major objective of O's research is to identify and locate living descendants of that family to enable those descendants to become acquainted with each other.

(ii) O's educational activities primarily serve the private interests of members of a single family rather than a public interest. Therefore, O is operated for the benefit of private interests in violation of the restriction on private benefit in §1.501(c)(3)-1(d)(1)(ii). Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

Example 2. (i) O is an art museum. O's sole activity is exhibiting art created by a group of unknown but promising local artists. O is governed by a board of trustees unrelated to the artists whose work O exhibits. All of the art exhibited is offered for sale at prices set by the artist. Each artist whose work is exhibited has a consignment arrangement with O. Under this arrangement, when art is sold, the museum retains 10 percent of the selling price to cover the costs of operating the museum and gives the artist 90 percent.

(ii) The artists in this situation directly benefit from the exhibition and sale of their art. As a result, the sole activity of O serves the private interests of these

artists. Because O gives 90 percent of the proceeds from its sole activity to the individual artists, the direct benefits to the artists are substantial and O's provision of these benefits to the artists is more than incidental to its other purposes and activities. This arrangement causes O to be operated for the benefit of private interests in violation of the restriction on private benefit in §1.501(c)(3)-1(d)(1)(ii). Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

Example 3. (i) O is an educational organization the purpose of which is to train individuals in a program developed by P, O's president. All of the rights to the program are owned by Company K, a for-profit corporation owned by P. Prior to the existence of O, the teaching of the program was conducted by Company K. O licenses, from Company K, the right to use a reference to the program in O's name and the right to teach the program, in exchange for specified royalty payments. Under the license agreement, Company K provides O with the services of trainers and with course materials on the program. O may develop and copyright new course materials on the program but all such materials must be assigned to Company K without consideration if the license agreement is terminated. Company K sets the tuition for the seminars and lectures on the program conducted by O. O has agreed not to become involved in any activity resembling the program or its implementation for 2 years after the termination of O's license agreement.

(ii) O's sole activity is conducting seminars and lectures on the program. This arrangement causes O to be operated for the benefit of P and Company K in violation of the restriction on private benefit in §1.501(c)(3)-1(d)(1)(ii), regardless of whether the royalty payments from O to Company K for the right to teach the program are reasonable. Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

* * * * *

(g) Interaction with section 4958--(1) Application process. An organization that applies for recognition of exemption under section 501(a) as an organization described in section 501(c)(3) must establish its eligibility under this section. The Commissioner may deny an application for exemption for failure to establish any of this section's requirements for exemption. Section 4958 does

not apply to transactions with an organization that has failed to establish that it satisfies all of the requirements for exemption under section 501(c)(3). See §53.4958-2 of this chapter.

(2) Substantive requirements for exemption still apply to applicable tax-exempt organizations described in section 501(c)(3)--(i) In general. Regardless of whether a particular transaction is subject to excise taxes under section 4958, the substantive requirements for tax exemption under section 501(c)(3) still apply to an applicable tax-exempt organization (as defined in section 4958(e) and §53.4958-2 of this chapter) described in section 501(c)(3) whose disqualified persons or organization managers are subject to excise taxes under section 4958. Accordingly, an organization may no longer meet the requirements for tax-exempt status under section 501(c)(3) because the organization fails to satisfy the requirements of paragraph (b), (c) or (d) of this section. See §53.4958-8(a) of this chapter.

(ii) Determining whether revocation of tax-exempt status is appropriate when section 4958 excise taxes also apply. In determining whether to continue to recognize the tax-exempt status of an applicable tax-exempt organization (as defined in section 4958(e) and §53.4958-2 of this chapter) described in section 501(c)(3) that engages in one or more excess benefit transactions (as defined in section 4958(c) and §53.4958-4 of this chapter) that violate the prohibition on inurement under this section, the Commissioner will consider all relevant facts and circumstances, including, but not limited to, the following--

(A) The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred;

(B) The size and scope of the excess benefit transaction or transactions (collectively, if more than one) in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes;

(C) Whether the organization has been involved in repeated excess benefit transactions;

(D) Whether the organization has implemented safeguards that are reasonably calculated to prevent future violations; and

(E) Whether the excess benefit transaction has been corrected (within the meaning of section 4958(f)(6) and §53.4958-7 of this chapter), or the organization has made good faith efforts to seek correction from the disqualified persons who benefited from the excess benefit transaction.

(iii) All factors will be considered in combination with each other.

Depending on the particular situation, the Commissioner may assign greater or lesser weight to some factors than to others. The factors listed in paragraphs (g)(2)(ii)(D) and (E) of this section will weigh more strongly in favor of continuing to recognize exemption where the organization discovers the excess benefit transaction or transactions and takes action before the Commissioner discovers the excess benefit transaction or transactions. Further, with respect to the factor listed in paragraph (g)(2)(ii)(E) of this section, correction after the excess benefit

transaction or transactions are discovered by the Commissioner, by itself, is never a sufficient basis for continuing to recognize exemption.

(iv) Examples. The following examples illustrate the principles of paragraph (g)(2)(ii) of this section. For purposes of each example, assume that O is an applicable tax-exempt organization (as defined in section 4958(e) and §53.4958-2 of this chapter) described in section 501(c)(3) for all relevant periods.

The examples are as follows:

Example 1. (i) O was created as a museum for the purpose of exhibiting art to the general public. In Years 1 and 2, O engages in fundraising and in selecting, leasing, and preparing an appropriate facility for a museum. In Year 3, a new board of trustees is elected. All of the new trustees are local art dealers. Beginning in Year 3 and continuing to the present, O uses almost all of its revenues to purchase art solely from its trustees at prices that exceed fair market value. O exhibits and offers for sale all of the art it purchases. O's Form 1023, "Application for Recognition of Exemption," did not disclose the possibility that O's trustees would be selling art to O.

(ii) O's purchases of art from its trustees at more than fair market value constitute excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these transactions are subject to the appropriate excise taxes provided in that section. In addition, O's purchases of art from its trustees at more than fair market value violate the proscription against inurement under section 501(c)(3) and §1.501(c)(3)-1(c)(2).

(iii) The application of the factors in §1.501(c)(3)-1(g)(2)(ii) to these facts is as follows. Beginning in Year 3, O does not engage in any regular and ongoing activities that further exempt purposes because almost all of O's activities consist of purchasing art from its trustees and exhibiting and offering for sale all of the art it purchases. The size and scope of the excess benefit transactions collectively are significant in relation to the size and scope of any of O's ongoing activities that further exempt purposes. O has been involved in repeated excess benefit transactions, namely, purchases of art from its trustees at more than fair market value. O has not implemented safeguards that are reasonably calculated to prevent such improper purchases in the future. The excess benefit transactions have not been corrected, nor has O made good faith efforts to seek correction from the disqualified persons who benefited from the

excess benefit transactions (the trustees). The trustees continue to control O's Board. Based on the application of the factors to these facts, O is no longer described in section 501(c)(3) effective in Year 3.

Example 2. (i) The facts are the same as in Example 1, except that in Year 4, O's entire board of trustees resigns, and O no longer offers all exhibited art for sale. The former board is replaced with members of the community who are not in the business of buying or selling art and who have skills and experience running educational programs and institutions. O promptly discontinues the practice of purchasing art from current or former trustees, adopts a written conflicts of interest policy, adopts written art valuation guidelines, hires legal counsel to recover the excess amounts O had paid its former trustees, and implements a new program of educational activities.

(ii) O's purchases of art from its former trustees at more than fair market value constitute excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these transactions are subject to the appropriate excise taxes provided in that section. In addition, O's purchases of art from its trustees at more than fair market value violate the proscription against inurement under section 501(c)(3) and §1.501(c)(3)-1(c)(2).

(iii) The application of the factors in §1.501(c)(3)-1(g)(2)(ii) to these facts is as follows. In Year 3, O does not engage in any regular and ongoing activities that further exempt purposes. However, in Year 4, O elects a new board of trustees comprised of individuals who have skills and experience running educational programs and implements a new program of educational activities. As a result of these actions, beginning in Year 4, O engages in regular and ongoing activities that further exempt purposes. The size and scope of the excess benefit transactions that occurred in Year 3, taken collectively, are significant in relation to the size and scope of O's regular and ongoing exempt function activities that were conducted in Year 3. Beginning in Year 4, however, as O's exempt function activities are established and grow, the size and scope of the excess benefit transactions that occurred in Year 3 become less and less significant as compared to the size and extent of O's regular and ongoing exempt function activities that began in Year 4 and continued thereafter. O was involved in repeated excess benefit transactions in Year 3. However, by discontinuing its practice of purchasing art from its current and former trustees, by replacing its former board with independent members of the community, and by adopting a conflicts of interest policy and art valuation guidelines, O has implemented safeguards that are reasonably calculated to prevent future violations. In addition, O has made a good faith effort to seek correction from the disqualified persons who benefited from the excess benefit transactions (its former trustees).

Based on the application of the factors to these facts, O continues to meet the requirements for tax exemption under section 501(c)(3).

Example 3. (i) O conducts educational programs for the benefit of the general public. Since its formation, O has employed its founder, C, as its Chief Executive Officer. Beginning in Year 5 of O's operations and continuing to the present, C caused O to divert significant portions of O's funds to pay C's personal expenses. The diversions by C significantly reduced the funds available to conduct O's ongoing educational programs. The board of trustees never authorized C to cause O to pay C's personal expenses from O's funds. Certain members of the board were aware that O was paying C's personal expenses. However, the board did not terminate C's employment and did not take any action to seek repayment from C or to prevent C from continuing to divert O's funds to pay C's personal expenses. C claimed that O's payments of C's personal expenses represented loans from O to C. However, no contemporaneous loan documentation exists, and C never made any payments of principal or interest.

(ii) The diversions of O's funds to pay C's personal expenses constituted excess benefit transactions between an applicable tax-exempt organization and a disqualified person under section 4958. Therefore, these transactions are subject to the appropriate excise taxes provided in that section. In addition, these transactions violate the proscription against inurement under section 501(c)(3) and §1.501(c)(3)-1(c)(2).

(iii) The application of the factors in §1.501(c)(3)-1(g)(2)(ii) to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transactions occurred. However, the size and scope of the excess benefit transactions engaged in by O beginning in Year 5, collectively, are significant in relation to the size and scope of O's activities that further exempt purposes. Moreover, O has been involved in repeated excess benefit transactions. O has not implemented any safeguards that are reasonably calculated to prevent future diversions. The excess benefit transactions have not been corrected, nor has O made good faith efforts to seek correction from C, the disqualified person who benefited from the excess benefit transactions. Based on the application of the factors to these facts, O is no longer described in section 501(c)(3) effective in Year 5.

Example 4. (i) O conducts activities that further exempt purposes. O employs C as its Chief Executive Officer. C, on behalf of O, entered into a contract with Company K to construct an addition to O's existing building. The addition to O's building is a significant undertaking in relation to O's other activities. C owns all of the voting stock of Company K. Under the contract, O paid Company K an amount that substantially exceeded the fair market value of

the services Company K provided. When O's board of trustees approved the contract with Company K, the board did not perform due diligence that could have made it aware that the contract price for Company K's services was excessive. Subsequently, but before the IRS commences an examination of O, O's board of trustees determines that the contract price was excessive. Thus, O concludes that an excess benefit transaction has occurred. After the board makes this determination, it promptly removes C as Chief Executive Officer, terminates C's employment with O, and hires legal counsel to recover the excess payments to Company K. In addition, O promptly adopts a conflicts of interest policy and significant new contract review procedures designed to prevent future recurrences of this problem.

(ii) The purchase of services by O from Company K at more than fair market value constitutes an excess benefit transaction between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, this transaction is subject to the appropriate excise taxes provided in that section. In addition, this transaction violates the proscription against inurement under section 501(c)(3) and §1.501(c)(3)-1(c)(2).

(iii) The application of the factors in §1.501(c)(3)-1(g)(2)(ii) to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transaction occurred. Although the size and scope of the excess benefit transaction were significant in relation to the size and scope of O's activities that further exempt purposes, the transaction with Company K was a one-time occurrence. By adopting a conflicts of interest policy and significant new contract review procedures and by terminating C, O has implemented safeguards that are reasonably calculated to prevent future violations. Moreover, O took corrective actions before the IRS commenced an examination of O. In addition, O has made a good faith effort to seek correction from Company K, the disqualified person who benefited from the excess benefit transaction. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

Example 5. (i) O is a large organization with substantial assets and revenues. O conducts activities that further exempt purposes. O employs C as its Chief Financial Officer. During Year 1, O pays \$2,500 of C's personal expenses. O does not make these payments under an accountable plan under §53.4958-4(a)(4) of this chapter. In addition, O does not report any of these payments on C's Form W-2, "Wage and Tax Statement," or on a Form 1099-MISC, "Miscellaneous Income," for C for Year 1, and O does not report these payments as compensation on its Form 990, "Return of Organization Exempt From Income Tax," for Year 1. Moreover, none of these payments can be disregarded under section 4958 as nontaxable fringe benefits and none consisted of fixed payments under an initial contract under §53.4958-4(a)(3) of

this chapter. C does not report the \$2,500 of payments as income on his individual federal income tax return for Year 1. O does not repeat this reporting omission in subsequent years and, instead, reports all payments of C's personal expenses not made under an accountable plan as income to C.

(ii) O's payment in Year 1 of \$2,500 of C's personal expenses constitutes an excess benefit transaction between an applicable tax-exempt organization and a disqualified person under section 4958. Therefore, this transaction is subject to the appropriate excise taxes provided in that section. In addition, this transaction violates the proscription against inurement in section 501(c)(3) and §1.501(c)(3)-1(c)(2).

(iii) The application of the factors in §1.501(c)(3)-1(g)(2)(ii) to these facts is as follows. O engages in regular and ongoing activities that further exempt purposes. The payment of \$2,500 of C's personal expenses represented only a de minimis portion of O's assets and revenues; thus, the size and scope of the excess benefit transaction were not significant in relation to the size and scope of O's activities that further exempt purposes. The reporting omission that resulted in the excess benefit transaction in Year 1 is not repeated in subsequent years. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

(3) Effective date. The rules in paragraph (g) of this section will apply with respect to excess benefit transactions occurring after the date of publication in the **Federal Register** of a Treasury Decision adopting these rules as final regulations.

PART 53--FOUNDATION AND SIMILAR EXCISE TAXES

Par. 3. The authority citation for part 53 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §53.4958-2, paragraph (a)(6) is added to read as follows:

§53.4958-2 Definition of applicable tax-exempt organization.

(a) * * *

(6) Examples. The following examples illustrate the principles of this section, which defines an applicable tax-exempt organization for purposes of section 4958:

Example 1. O is a nonprofit corporation formed under state law. O filed its application for recognition of exemption under section 501(c)(3) within the time prescribed under section 508(a). In its application, O described its plans for purchasing property from some of its directors at prices that would exceed fair market value. After reviewing the application, the IRS determined that because of the proposed property purchase transactions, O failed to establish that it met the requirements for an organization described in section 501(c)(3). Accordingly, the IRS denied O's application. While O's application was pending, O engaged in the purchase transactions described in its application at prices that exceeded the fair market value of the property. Although these transactions would constitute excess benefit transactions under section 4958, because the IRS never recognized O as an organization described in section 501(c)(3), O was never an applicable tax-exempt organization under section 4958. Therefore, these transactions are not subject to the excise taxes provided in section 4958.

Example 2. O is a nonprofit corporation formed under state law. O files its application for recognition of exemption under section 501(c)(3) within the time prescribed under section 508(a). The IRS issues a favorable determination letter in Year 1 that recognizes O as an organization described in section 501(c)(3). Subsequently, in Year 5 of O's operations, O engages in certain transactions that constitute excess benefit transactions under section 4958 and violate the proscription against inurement under section 501(c)(3) and §1.501(c)(3)-1(c)(2). The IRS examines the Form 990, "Return of Organization Exempt From Income Tax", that O filed for Year 5. After considering all the relevant facts and circumstances in accordance with §1.501(c)(3)-1(g), the IRS concludes that O is no longer described in section 501(c)(3) effective in Year 5. The IRS does not examine the Forms 990 that O filed for its first four years of operations and, accordingly, does not revoke O's exempt status for those years. Although O's tax-exempt status is revoked effective in Year 5, under the lookback rules in §53.4958-2(a)(1) and §53.4958-3(a)(1) of this chapter, for a period of five years prior to the excess benefit transactions that occurred in Year 5, O was an applicable tax-exempt organization and O's directors were disqualified persons

as to O. Therefore, the transactions between O and its directors during Year 5 are subject to the appropriate excise taxes provided in section 4958.

* * * * *

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.