How Officers and Directors of Nonprofits Can Stay out of Trouble under the Excess Benefit Rules

By Lisa Nachmias Davis

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As this article is being written, the headlines are full of big business scandals—Enron, Worldcom and Martha Stewart. The public seems to have lost faith in the market as an institution and in the ability of the accounting profession to police itself. Fifteen years ago, however, the spotlight was on the nonprofit world and the lavish spending, insider profits and fraud committed by William Aramony, then CEO of United Way of America. Aramony's breach of trust caused a massive loss of public faith in the ability of our charitable institutions to police themselves. The scandal created a backlash that has now reached its concluding phase with the IRS issuing final "excess benefit" regulations under Section 4958 of the Internal Revenue Code and the tax court applying that section to require repayment of millions of dollars in "excess benefits" and penalties.[1]

Section 4958 and the excess benefit regulations have gone unnoticed by many lawyers involved with charitable organizations, but those who don't pay attention may risk the same kind of public humiliation now confronting the accounting firm of Arthur Andersen. The technicalities of the rules may elude even those who adhere scrupulously to procedures under the Connecticut Revised Nonstock Corporation Act (Nonstock Act) described by James I. Lotstein in the March 2002 edition of the *Connecticut Lawyer*. This article will first explain the core concepts of the rules and then conclude with a simple checklist for attorneys who are counsel to, or serve on, the boards of tax-exempt organizations.

Section 4958

In 1996, responding to the United Way/Aramony scandal, Congress adopted Section 4958 of the Internal Revenue Code (in this article, IRC or Code). These provisions, known as the "intermediate sanctions" legislation, were intended to give the IRS an additional weapon to fight corruption in the charitable sector.[2] (Previously, the IRS could only threaten such organizations with revocation of tax-exempt status, risking loss of the services provided to the organization's often poor and needy constituencies.) The new rules were intended to attack the "bad apples" rather than the institutions themselves. Instead of punishing the organization, those who took advantage of their influence to obtain "excess benefits" would be penalized. The idea wasn't new: similar rules had governed "private foundations," charities controlled by corporations or a few wealthy individuals, since 1969.

After several rounds of proposals, some including especially restrictive provisions, the IRS has now issued its *final* regulations under Section 4958. 67 Fed. Reg. 3076 (January 23, 2002). These final regulations retain enough complexity to worry any attorney involved in a "deal" with a tax-exempt organization.

What Is an Excess Benefit?

Section 4958 basically allows for the imposition of an excise "tax" as a penalty on "insiders" and those connected to them, known as "disqualified persons" (DQs), who receive an "excess benefit" from transactions with a tax-exempt organization. "Excess benefit" occurs whenever "the value of the economic benefit provided exceeds the value of the consideration received for providing the benefit," without regard to motive or intent.[3] Reg.[4] § 53.4958-4. Even if a DQ is involved, however, there is no "excess benefit transaction" and no IRS problem so long as the benefit to the DQ does not exceed the consideration. In other words, if an organization enters into a contract with John Jones, member of the board and *ipso facto* DQ, to supply cleaning fluid, and the compensation is reasonable for the cleaning fluid provided, no problem. There is nothing wrong with this, from the IRS point of view, even if there were 200 other companies that wanted to provide cleaning fluid at the same price and John Jones got the deal because he "knew the right people" by sitting on the board.

"Indirect Benefit" or Kickbacks

On the other hand, even if the nonprofit organization pays a reasonable price, a secret "kickback" arrangement to a DQ will result in "excess benefit" to the DQ, because the DQ did not provide the consideration. Continuing with the example, if the Karl Kyser company gets the contract at the going price, but "kicks back" ten percent to John Jones under the table, there is excess benefit to John Jones. Reg. § 53.4958-4(a)(2).[5] This apparently *differs* from the Nonstock Act rule under which a transaction with a disqualified person is not voidable if it is "fair" to the corporation. C.G.S. § 33-1128. In my example, the organization is in exactly the same place as it would have been without a kickback, but there is still an "excess benefit."

"Unreasonable" Employee Compensation Is an Excess Benefit Too

Those familiar with corporate tax deductions in the for-profit sector already know that "unreasonable" compensation is not deductible. In the nonprofit sector, it is an "excess benefit." This is an area of great anxiety for large nonprofit organizations like hospitals, universities and national organizations trying to lure and retain highly compensated professionals and managers. Indeed, it was William Aramony's compensation package and Concorde flights that ultimately led to his ouster. Unfortunately, while the final regulations explain what gets counted when measuring the "benefit" conferred in a compensation package, they offer no bright line for what is "excess," not even when it comes to the ticklish problem of how to return the "excess" excess employee benefit and thereby escape further penalties.

Who *Is* a "DQ"?

"Excess benefit" can occur only when a transaction involves a DQ, that is, an insider, an insider's family member, or an entity thirty-five percent controlled by insiders.[6] ("Insider" is *not* a statutory term but is an informal way to describe what the IRS means by "any person [including a corporation] who was, at any time during the five-year period ending on the date of [the] transaction, in a position to exercise substantial influence over the affairs of the organization," IRC § 4958(f)(1)(A), *e.g.*, an officer, director or highly compensated employee.)

One relationship that has troubled many in the nonprofit community but apparently has not troubled either Congress or the state legislature, is an unpaid position on the board of a second, unrelated nonprofit organization. Assuming that both qualify as exempt under IRC § 501(c)(3), this creates no problem with respect to transactions (including grant awards) between the organizations. Reg. § 53.4958-3(d)(1). Many in the nonprofit community feel, however, that the situation creates an image problem or potential for "pass-through" indirect benefit to individuals. Therefore, it may be preferable that such dual-fiduciaries follow the rules that apply to DQs.

"Initial Contract" Exception

Because the "influence" issue has been a tricky one for both tax-exempt organizations and the IRS,[7] the final regulations retain the "initial contract" exception, introduced in the last round of temporary regulations, to resolve the conundrum of which comes first, contract or influence. The first time a contract is entered into that gives influence over the nonprofit organization to a private party—for example, a "revenue-sharing" contract whereby the private party that controls the inflow gets sixty percent of the returns—the private party does not become an insider or other DQ by virtue of that control.[8] However, the next time the contract is up for modification or renewal, that party is now a DQ.

Who Pays the Penalty?

Under the law, the penalty is imposed on the DQ, e.g., John Jones*, and not the organization.* IRC § 4958(a). In the earlier example, John Jones must pay a "first tier" penalty at the rate of twenty-five percent of whatever is found to be "excess," and if he doesn't pay back the actual "excess" amount (plus penalty) within ninety days from getting an IRS notice, the penalty increases to a "second tier" of 200 percent of the excess. IRC § 4958(b). In theory, excess benefit of $4,000 not repaid could mean fines of $8,000 plus the $4,000 to be repaid for a total of $12,000.

Members of management may also be

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on the hook. Anyone in a control position who "participates knowingly" faces a ten percent tax. IRC § 4958(a)(2). That could mean other board members who voted to approve the transaction even if they didn't benefit. While Connecticut law and the organization's bylaws may require indemnification, that won't help John Jones if the organization is bankrupt, and it also won't help John Jones if he abrogated his fiduciary duties and isn't entitled to indemnification. C.G.S. § 33-1117(d).

Of course, just because John Jones pays doesn't mean the organization is home free. "Private inurement" or excess "private benefit" are still grounds for revoking an organization's tax exemption. Section 4958 is in addition to, not instead of, the IRS' existing remedies.

Danger Lurks

What seems like practical business advice may lead to serious trouble when transactions with DQs are involved. The problems are demonstrated by the recent case of *Caracci v. Commissioner*, 118 Tax Court No. 25 (May 22, 2002). A family set up a tax-exempt corporation to run home health agencies. Many years later, with changes in the health care industry, the agencies began to run continual losses. The family's attorney advised that if the assets of the nonprofit were transferred to a for-profit corporation in exchange for an assumption of debt, the for-profit would be better equipped to weather the economic problems due to reimbursement advantages from which it might benefit, and by extension, the individual shareholders (who would be the nonprofit's board members) would also benefit. On their attorney's recommendation, the individual board members created the for-profit, obtained appraisals of the nonprofit's assets and, as board members of the nonprofit, voted to approve the sale to the for-profit. The IRS found, however, that the board had undervalued the nonprofit's intangible assets, and that the for-profit now owed the nonprofit $5 million. Because an excess benefit had accrued to a DQ (a for-profit owned entirely by the nonprofit's board members, the "insiders"), the statutory penalties to be paid by the for-profit were potentially another $1.25 million. One suspects that the attorney who recommended and implemented the transaction may well have felt more than a little uncomfortable upon reading the court's decision.

Attorneys can now point to a specific economic risk from "impropriety" rather than relying on virtuous rhetoric or the remote threat of loss of exemption.

The point is that these excess benefit penalties are not a slap on the wrist and must be taken very seriously. Further, the IRS has an economic incentive to enforce these penalties and the bigger the fish, the more it should fear the net. This does not mean, however, that small organizations or their attorneys can ignore the sanctions with impunity. From a funding perspective, the scandal that can swirl around any alleged impropriety may be as damaging as an all-out IRS assault. For the smaller organization, therefore, warnings by attorneys about the threat of intermediate sanctions may help keep well-intentioned board members and management from straying into dangerous waters. Attorneys can now point to a specific economic risk from "impropriety" rather than relying on virtuous rhetoric or the remote threat of loss of exemption.

Safe Harbor Protections

Even though a transaction between a nonprofit and a DQ may be perfectly legitimate, it always has the potential of looking "fishy." What seemed reasonable to the board at the time of the transaction may seem unreasonable to the IRS after the fact. This is especially true of employee compensation. Because of this uncertainty, the regulations include "safe harbor" procedures that, if followed, will create a rebuttable presumption of propriety. It stands to reason that organizations will prefer to keep to the safe harbor whenever possible. Alas, the safe harbor provisions are lengthy and detailed. The full text of Reg. § 53.4958-6 is approximately as long as this article. When the stakes are high, it behooves the attorney to parse this regulation word-for-word. For daily use and quick reference, however, I append a short procedural checklist. These practical "ground rules" approximate the safe harbors but should not be relied upon as definitive.

Needless to say, Section 4958 and the regulations do nothing to make administration of a nonprofit organization any easier. In trying to catch the bad guys, the IRS is putting the good guys through an enormous amount of anxiety and trouble. It is to be hoped that the regulations will prevent real abuses and not simply increase administrative costs. At the very least, as lawyers we must be mindful of these requirements both when sitting on boards and when giving advice. **CL**

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Notes

1. *Caracci v. Commissioner*, 118 Tax Court 379 (May 22, 2002). The Internal Revenue Service's Advisory Committee on Tax Exempt and Government Entities (ACT), specifically referencing recent "corporate responsibility" and "ethical accounting" issues, requested comments this July on possible changes to Form 990 that would require disclosure of details on all transactions between organizations and "insiders." IRS News Release IR-02-87; Announcement 2002-87.
2. The excess benefit rules apply to organizations—corporate or otherwise—exempt under IRC §§ 501(c)(3) or 501(c)(4). IRC § 4958(e). (Organizations exempt under IRC § 501(c)(4) often include advocacy groups.) "Private foundations," which are exempt under § 501(c)(3) but are controlled and funded by a small group, are not subject to these rules but are subject to similarly tough

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Checklist

Where There May Be a Conflict of Interest

- Disclosure. If there is any kind of potential financial benefit to a DQ, the insider involved should disclose to the board the nature of the interest as well as any other relevant facts about the transaction that the board should know in making its decision. (This is really a requirement of Connecticut law, C.G.S. § 33-1127; *see* Lotstein, *supra*—but from a practical standpoint is essential to compliance with the excess benefit rules as well.) Management must make sure that parties to transactions, and board members, disclose all such connections so that a conflicting interest that may give rise to "excess benefit" is detected ahead of time. Regular disclosure requests are a must.

- Recusal. Reg. § 53.4958-6(c)(1)(ii). The DQ should not be present during the deliberations or the vote. Think of this as the "leave the room" requirement. (Answering questions is permitted.) This also applies to any vote regarding whether there is, or is not, a conflict of interest in the first place. The decision makers must be composed entirely of (not just controlled by) individuals who do not have a conflict of interest. A board member who is an attorney for the disqualified person would also be considered to have an "interest" and should also leave the room. If the attorney stays, the organization may not be able to rely on the safe harbor's requirement that the transaction be approved by persons without a "conflict." Reg. § 53.4958-6(c)(1)(iii)(C).

- Data. Reg. § 53.4958-6(a)(2). The board should be sure to obtain enough documented data as to comparability, including competitive bids or some other thorough price comparison, before it decides to contract with the interested party. Whenever possible, at least three bids should be required (this is the safe harbor for organizations with gross receipts of less than $1 million annually; Reg. § 53.4958-6(c)(2)(ii)). The IRS is especially skeptical about arrangements that have revenue-sharing, percentage-type compensation. "Reasonableness" isn't determined until the compensation becomes fixed. When entering into a deal with a flexible compensation arrangement, include a cap that the IRS can find reasonable. Reg. § 53.4958-6(d)(2).

- Advance Approval. Reg. § 53.4958-6(a)(1). The transaction must be approved in advance by an "authorized" body, usually the full board or a committee with authority to act. By implication, this means that the board must be more cautious about delegating decisions on transactions to officers, although "committee" may include a committee of one. The approval should include a finding that the transaction is fair to the organization and if the transaction involves accepting a higher bid from a DQ than offered by an unrelated party, should explain the reasons for the decision. The "finding of fairness" is helpful under C.G.S. § 33-1129, but is also a good way of reminding the board to focus on the need to justify the transaction to the outside world, including the IRS.

- When in Doubt, Get an Opinion (full employment for tax lawyers, CPAs, and "independent valuation experts"?). The ten percent penalty that can be imposed on management for "knowing" participation in an excess benefit transaction can be defended in part if "after full disclosure of the factual situation to an appropriate professional, the organization manager relies on a reasoned written opinion of that professional with respect to elements of the transaction within the professional's expertise." Reg. § 53.4958-1(d)(4)(iii). Note, however, that a professional opinion is no defense on the question of whether or not the transaction actually is an excess benefit transaction, only a defense against the ten percent penalty on management.

- Contemporaneous Minutes. The minutes should document all of the preceding points, and should be circulated no later than the next meeting (or within sixty days, if later), and approved "within a reasonable time," presumably by the following meeting. Reg. § 53.4958-6(c)(3)(ii). Board members concerned about their own liability should be particularly anxious to go on record as having voted against the transaction.

rules under IRC §§ 4941-4946. The final regulations also clarified that the rules do not apply to governmental units or their affiliates.

3. Note, however, that the twenty-five percent "first tier" tax discussed later may be abated if the benefit is "corrected" (repaid) within ninety days from the IRS notice of assessment and "reasonable cause and not willful neglect" can be shown. IRC § 4962(a). In some instances, "correction" is easier said than done (as was pointed out with some heat in the comments on the proposed regulations), but those issues are beyond the scope of this article. In general, however, the objective of "correction" is to place the organization in the position it would have been in had the DQ acted according to the "highest standards." Reg. § 53.4958-7.
4. The Treasury Regulations are codified at Title 26 of the Code of Federal Regulations, and are referred to throughout as "Reg."
5. Reg. § 53.4958-4(a)(2). "*Economic benefit provided indirectly*. (iii) *Through an intermediary*. An applicable tax-exempt organization may provide an excess benefit indirectly through an intermediary. An intermediary is any person (including an individual or a taxable or tax-exempt entity) who participates in a transaction with one or more disqualified persons of an applicable tax-exempt organization. For purposes of Section 4958, economic benefits provided by an intermediary will be treated as provided by the applicable tax-exempt organization when—(A) An applicable tax-exempt organization provides an economic benefit to an intermediary; and (B) In connection with the receipt of the benefit by the intermediary— (1) There is evidence of an oral or written agreement or understanding that the intermediary will provide economic benefits to or for the use of a disqualified person; or (2) The intermediary provides economic benefits to or for the use of a disqualified person without a significant business purpose or exempt purpose of its own."
6. The IRC definition of a "family member" sufficiently connected to an insider to become a DQ does not include "anyone having the same home as" the insider, as does the Nonstock Act, but in other ways the IRC definition is considerably broader.
7. *See United Cancer Council v. Commissioner*, 165 F.3d 1173 (7th Cir. 1999), reversing 109 T.C. No. 17 (1998).
8. This assumes that the contracting party "substantially performs" the contractual obligations—provides the consideration for the benefit.