

Automatic Excess Benefit Transactions in a Nutshell
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NUTSHELL: If you pay a benefit intended to be compensation someone better treat it as compensation for tax purposes before the IRS catches you or it will be treated as an excess benefit transaction regardless of whether the benefit when added to other compensation would otherwise be considered reasonable compensation. In other words, you can't argue that the total compensation was reasonable if you didn't treat the benefit as compensation for tax purposes.

BACKGROUND: United Way-Aramony scandal was to Intermediate Sanctions what Enron was to Sarbanes-Oxley. Excess Benefit Transaction rules enacted in 1996 in response to United Way scandal.

Introduction and Statutory Scheme. Internal Revenue Code Section 4958 imposes certain excise taxes against certain individuals involved in an "excess benefit transaction" with an organization exempt from income tax under Code Section 501(c)(3) or 501(c)(4) ("EO"). An EO also includes any organization that was described in section 501(c)(3) or (4) and was exempt from tax under section 501(a) at any time during a five-year lookback period ending on the date of an excess benefit transaction. Although the section is effective for any transaction occurring after September 14, 1995, final regulations were just issued on January 22, 2002.

The excess benefit transaction rules are part of the "Intermediate Sanction" reforms which give the IRS a more effective weapon to deter transactions where a person with substantial influence over the affairs of an EO uses that influence to be unjustly enriched. The classic example is where the founder and President of the organization is paid an excessive amount of compensation for services to the organization. In the past, the Internal Revenue Services' ("IRS") only recourse when discovering such an abuse was to revoke the tax exempt status of the organization. This approach did not work to deter such behavior as the person responsible for, and receiving, the unjust enrichment was not penalized, only the organization. Further, in the case of a Section 501(c)(3) charitable organizations, donor's would be penalized by the organization losing its exempt status. In addition, the charitable beneficiaries were hurt because the organization either would not survive as a taxable entity or because fewer dollars were available for the charitable purpose due to having to pay income tax. Thus, Section 4958 was enacted to penalize the persons involved in the excess benefit transaction rather than just the organization, as well as to permit the IRS to impose the tax without revoking the tax exempt status of the organization.

Excess Benefit Transaction. An excess benefit transaction is any transaction in which an economic benefit is provided by an EO directly or indirectly to or for the use of a "disqualified person," and the value of the benefit exceeds the value of any consideration given for it, including services.

Initial Tax. Under Code Section 4958, there is a tax on individuals involved in excess benefit transactions. The tax is equal to 25% of the value of the excess benefit provided and is imposed on the disqualified person. Thus, if a disqualified person is deemed by the IRS to be paid more than reasonable compensation, he/she would be subject to a 25% tax on the overpayment. In addition, if an organization manager, such as a member of the EO's Board, "knowingly" participates in an excess benefit transaction, that person would be subject to a

10% tax on the overpayment. However, under the regulations, an organization manager's participation will not be considered "knowing" if, after full disclosure of the factual situation to a professional, the organization manager relies on a reasoned written opinion with respect to elements of the transaction within the professional's expertise. Thus, it is in the personal interest of members of the authorized body to seek an opinion letter from legal counsel, accountants, or consultants to limit their personal risk. The organization manager will avoid the 10% tax even if the professional turns out to be wrong, as long as he or she relied on the professional's advice in good faith.

Disqualified Person. A disqualified person is any person who was in a position to exercise substantial influence over the affairs of an EO at any time during the five-year period ending on the date of the transaction. Under the regulations, members of the governing body, officers, and certain relatives of the above are deemed to be disqualified persons. An organization manager is any officer, director, or trustee of such organization, or any individual having powers or responsibilities similar to those of officers, directors, or trustees of the organization, regardless of title.

Second Tax If Not Corrected. Should an organization be found to have entered into an excess benefit transaction, a second-level tax may be imposed on a disqualified person if there is no correction of the excess benefit on or prior to the earlier of: (1) the mailing of a deficiency notice with respect to the 25% tax or (2) the date of assessment. The second-level tax is 200% of the amount of the excess benefit. This second-level tax can be avoided if the transaction is cured within the prescribed time frame. That is, if the excess benefit is paid back to the exempt organization.

COMPENSATION. One would think that, by definition, reasonable compensation paid for services rendered is not an excess benefit transaction. Not so, under the regulations. In order to treat an economic benefit as being compensation for services and tested under the reasonableness standard the EO must have intended the economic benefit as compensation and must have some evidence of such intent or reasonable cause for failing to do so. An organization is treated as clearly indicating its intent to provide an economic benefit as compensation for services only if the organization provides written substantiation that is "contemporaneous" with the transfer of the economic benefit at issue. If an organization fails to provide this contemporaneous substantiation, any services provided by the disqualified person will not be treated as provided in consideration for the economic benefit for purposes of determining the reasonableness of the transaction. Treas. Reg. §53.4958-4(c)(1). Of course, as shown below, just as "exclusively charitable" doesn't really mean exclusively in exempt organization law, "contemporaneous substantiation" doesn't really mean "contemporaneous".

Exception for Nontaxable Benefits. An exempt 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 (e.g., employer-provided health benefits and contributions to a qualified pension, profit-sharing, or stock bonus plan under section 401(a), and benefits described in sections 127 and 137). However, such benefits do count in determining the reasonableness of a person's compensation for purposes of section 4958. Treas. Reg. §53.4958-4(c)(2)

Contemporaneous substantiation. An EO provides contemporaneous written substantiation of intent to provide an economic benefit as compensation if:

1. The EO reports the economic benefit as compensation on an original Federal tax information return with respect to the payment (e.g., Form W-2, Form 1099, or Form 990), or on an amended Federal tax information return filed prior to IRS audit;
2. The recipient disqualified person reports the benefit as income on the person's original Federal tax return (e.g., Form 1040), or on the person's amended Federal tax return filed prior to the earlier of the following dates:
 - (a) Commencement of an IRS examination; or
 - (b) The first written notice from the IRS of a potential excess benefit transaction involving either the applicable tax-exempt organization or the disqualified person.Treas. Reg. §53.4958-4(c)(3)

Failure to report due to reasonable cause. If an applicable tax-exempt organization's failure to report an economic benefit as required under the Internal Revenue Code is due to reasonable cause then the organization will be treated as having clearly indicated its intent to provide an economic benefit as compensation for services. However, this reasonable cause standard is stricter than in other areas of tax law. To show reasonable cause, an applicable tax-exempt organization must establish that there were significant mitigating factors with respect to its failure to report (as described in Treas. Reg §301.6724-1(b)), or the failure arose from events beyond the organization's control (as described in Treas. Reg §301.6724-1(c)), and that the organization acted in a responsible manner both before and after the failure occurred (as described in Treas. Reg §301.6724-1(d)). Id.

Other evidence. Other written contemporaneous evidence may be used to demonstrate that the appropriate decision-making body or an officer authorized to approve compensation approved a transfer as compensation for services in accordance with established procedures, including but not limited to--

- (1) An approved written employment contract executed on or before the date of the transfer;
- (2) Documentation satisfying the requirements for the reasonableness presumption indicating that an authorized body approved the transfer as compensation for services on or before the date of the transfer; or
- (3) Written evidence that was in existence on or before the due date of the applicable Federal tax return of the organization or disqualified person (e.g., 990 or 1040) including extensions but not amendments, of a reasonable belief by the applicable tax-exempt organization that a benefit was a nontaxable benefit. Id.

IRS CPE ON AUTOMATIC EXCESS BENEFIT TRANSACTIONS. In late 2003 the IRS published on its Web site a CPE article for agents titled " 'Automatic' Excess Benefit Transactions Under IRC 4958", (www.irs.gov/charities/index.html). In the article, the IRS jumped on the regulations requirement that the EO must have intended the benefit to be compensation and have contemporaneous substantiation in stating that if the EO does not have such substantiation, the benefit will automatically be an excess benefit transaction. The reasonableness standard will not apply.

In March 2004, the IRS announced it would roll out a compliance initiative regarding automatic excess benefit transactions in which it will contact hundreds of organizations. In May, Exempt Organizations Director Steve Miller announced the IRS is contacting between 100-200 EOs reporting an executive with compensation of at least \$1,000,000 but that smaller organizations will also be looked at. From these several will be audited.

Spitzer v. Grasso, (available at www.oag.state.ny.us/press/2004/may/may24a_04.html). The IRS initiative is likely due in part to the press coverage of the alleged unreasonable compensation paid to the former Executive Director of the New York Stock Exchange, Richard Grasso, and the fact that the New York Attorney General is suing him for recovery under the New York Not-for-Profit Corporation statute. It should be noted that Section 4958 does not apply to this case because while organized as a not for profit corporation, the New York Stock Exchange is not tax exempt.

BOTTOM LINE- CONTEMPORANEOUS IS NOT CONTEMPORANEOUS. All EOs should be examining the compensation and economic benefits to determine if substantiation or a change in position is needed. There is still time to make changes before being contacted by the IRS. It seems that if an EO is merely contacted by the IRS inquiring about compensation (soft contact) as opposed to being notified of an examination, the EO can still file an amended return to report a benefit as compensation and cure the automatic excess benefit. However, the disqualified person could not cure the automatic excess benefit transaction by reporting it on an amended return once the EO was contacted.

Further, all EOs should ensure that they have a written accountable plan for any expense allowances for disqualified persons. Amounts paid under accountable expense allowance arrangements that meet the requirements of Treas. Reg §1.62-2(c) are disregarded when determining whether an excess benefit has occurred. However, if expenses are paid or reimbursed pursuant to a nonaccountable plan, the payment should be treated as compensation or it will be an automatic excess benefit transaction. To be an accountable plan the expense allowance arrangement must require that the expenses have a business purpose, that they be substantiated, and any amounts paid in excess of the substantiated expenses must be returned.

Finally, in this time of increased scrutiny it is a good practice for EOs to have well documented positions on compensation paid.