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<u>Suggested Reading</u>:

Today Matters

By John C. Maxwell

When the firehose of daily life hits you, *Today Matters* offers practices to help you manage and prioritize what is most important.

Bonnie Wyllie

THE PERSONAL LIABILITY OF BOARD OF DIRECTORS OF NONPROFITS FOR THE TAX ON EXCESS BENEFIT TRANSACTIONS:

<u>WAYS TO PREVENT OR REDUCE IT</u>

Many of our clients, referral partners and friends agree to serve on the boards of various charities and may not realize that they can be personally liable for a tax on excess benefits transactions under Internal Revenue Code ("IRC") Section 4958. The following is an overview of this statute and its regulations.

A. <u>Introduction to Excess Benefit Transactions ("EBT")</u>

For an organization to obtain or maintain exempt status, no part of the net earnings can inure to the benefit of any private individual." [1] The regulations make it clear that private individuals in control of the organization are prohibited from personally benefiting at the expense of the tax-exempt organization.

Prior to the enactment of IRC Section 4958, *Taxes on Excess Benefit Transactions,* if a tax-exempt organization had any private inurement, the IRS' only option was to revoke the organization's tax-exempt status. Since the enactment of IRC Section 4958 in 1995, the IRS has the discretion to revoke an organization's tax-exempt status, impose an excise tax, or both. The excise tax for tax-exempt organizations is sometimes referred to as an "intermediate sanction" because the penalty it imposes is not as severe as revocation of tax-exempt status.

[1] IRC Section 501(c)(3)

An example of an excess benefit transaction can occur when a person having substantial influence over a tax-exempt organization, such as a top management official, enters into an arrangement or transaction with the organization and does not pay or provide services equal to the fair market value of the asset or payment received from the tax-exempt organization.[2] In essence, this person is overpaid, which diminishes the assets available for the organization's exempt purpose. IRC Section 4958 treats the overpayment as an excess benefit and imposes an excise tax on the person receiving the overpayment. If the overpayment is not repaid, another excise tax will be imposed on that person. In addition, any board member that approved the transaction resulting in an overpayment will be personally liable for an excise tax as well.

B. The Excise Tax of IRC § 4958

IRC § 4958(a)(1) imposes a **25%** excise tax, which is a first-tier tax, on any disqualified person who engages in an excess benefit transaction with the tax-exempt organization.[3] Stated another way, a disqualified person who receives an excess benefit from a transaction is liable for a tax equal to **25%** of the amount of the excess benefit.

IRC § 4958(a)(2) imposes a **10%** excise tax, which is a first-tier tax, on any organization manager that participated in the excess benefit transaction, knowing that it was an excess benefit transaction, unless this manager's participation was not willful and is due to reasonable cause.[4] The term "organization manager" includes board members. The maximum amount of tax imposed on organization managers for a single excess benefit transaction is **$20,000**.[5] Any manager who is found to have participated in the excess benefit transaction is liable for the tax.

If more than one person is liable for the first- or second-tier tax, all persons shall be jointly and severally liable for the tax.[6]

If a first-tier tax has been imposed on a disqualified person and he or she has not corrected or repaid the excess benefit in full within the taxable period, then IRC § 4958(b) imposes a second-tier tax on the disqualified person equal to **200%** of the amount of the excess benefit.[7] The taxable period[8] begins on the date the transaction occurs and ends on the earliest of the date the IRS mails the notice of deficiency or the date the IRS assesses the first-tier tax on the disqualified person.

[2] IRC § 4958(c)(1)
[3] IRC § 4958(a)(1)
[4] IRC § 4958(a)(2)
[5] IRC § 4958(d)(2)
[6] IRC § 4958(d)(1)
[7] IRC § 4958(b)
[8] IRC § 4658(f)(5)

If any person is liable for the excise tax under IRC § 4958 and their act or failure to act is not due to reasonable cause, then **a penalty equal to the amount of the excise tax of IRC § 4958** will be imposed if this person has either previously been liable for a tax under IRC § 4958 or this person's act or failure to act is both willful and flagrant.[9] For example, if a person is subject to the **200%** tax of IRC § 4958 and his actions were both willful and flagrant, then an additional **200%** tax can be imposed under IRC §6884 for a total tax of **400%**. A willful and flagrant act (or failure to act) is one which is voluntarily, consciously, and knowingly committed in violation of IRC § 4958 and which appears to a reasonable man to be a gross violation.[10]

C. Defining the Persons Involved in an Excess Benefit Transaction

The tax on excess benefit transactions applies to disqualified persons and organization managers. Stated very simply, a disqualified person is the one who receives the excess benefit from the tax-exempt organization, and an organization manager is one who allows the disqualified person to receive the excess benefit. An organization manager can also be a disqualified person and will be liable for both the **10%** and **25%** tax, if he or she receives an excess benefit.[11]

1. **Who Can Be a Disqualified Person?** There are three categories of disqualified persons[12] that can be involved in an EBT, and there are some special rules that apply to supporting organizations and donor-advised funds.

   a. ***Persons Having Substantial Influence.*** Those persons who are considered, by reason of their position or relationship to the organization, to exert substantial influence over a tax-exempt organization's affairs.[13]

      - The Board of Directors (or voting members of the governing body called by any other name)
      - Top Management Officials, such as Presidents, Chief Executive Officers, or Chief Operating Officers
      - Top Financial Officials, such as Treasurers and Chief Financial Officers

   b. ***Family Members.*** Family members of a disqualified person or an entity in which a disqualified person owns a thirty-five percent interest are defined

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[9] IRC § 6684; Treas. Reg. §301.6684-1
[10] Treas. Reg. § 1.507-1(c)(2)
[11] Treas. Reg. § 53.4958-1(a)
[12] IRC § 4958(f)(1)
[13] Treas. Reg. §53.4958-3(c)

statutorily as disqualified persons.[14] Family members[15] are defined as: spouse, brothers or sisters (by whole or half-blood) and their spouses, ancestors, children and their spouses, grandchildren and their spouses, and great grandchildren and their spouses.

c. ***Thirty-five Percent Controlled Entity.*** An entity is considered a disqualified person, if a person having substantial influence over the affairs of the organization owns more than thirty-five percent of one of the following entities,[16] either directly or indirectly through constructive ownership:[17]

- A corporation in which the person owns more than 35% of the total combined voting power;[18]
- A partnership in which the person owns more than 35% of the profits interest;[19] or
- A trust or estate in which the person owns more than 35% of the beneficial interest.[20]

2. **Who Can Be an Organization Manager?** An organization manager is any officer, director, or trustee of a tax-exempt organization, or any individual having powers or responsibilities similar to those of officers, directors, or trustees of the organization, regardless of title.

D. Critical Factors in Excess Benefit Transactions

There are three critical factors that determine whether it will be possible for an organization manager involved in an excess benefit transaction to obtain an abatement of the excise taxes.

1. **Participation**. Participation includes silence or inaction on the part of an organization manager where the manager is under a duty to speak or act, as well as any affirmative action by such manager. An organization manager is not considered to have participated in an excess benefit transaction, however, where

[14] Treas. Reg. §53.4958-3(b)
[15] Treas. Reg. §53.4958-3(b)(1)
[16] Treas. Reg. §53.4958-3(b)(2)
[17] IRC § 267(c)
[18] Treas. Reg. §53.4958-3(b)(2)(i)(A)
[19] Treas. Reg. §53.4958-3(b)(2)(i)(B)
[20] Treas. Reg. §53.4958-3(b)(2)(i)(C)

the manager has expressed his or her opposition and has not affirmatively voted for the transaction.[21]

2. **Knowledge**. A manager participates in a transaction knowingly only if the person:[22]

a. Has actual knowledge of sufficient facts so that, based solely upon those facts, such transaction would be an excess benefit transaction;[23]

b. Is aware that such a transaction under these circumstances may violate the provisions of Federal tax law governing excess benefit transactions;[24] and

c. Negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the manager is in fact aware that it is such a transaction.[25]

3. **Willfulness**. Participation by an organization manager is willful if it is voluntary, conscious, and intentional. 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 manager does not know that the transaction in which the manager is participating is an excess benefit transaction.[26]

E. Protective Measures to Reduce an EBT Once It Has Occurred

1. **Correction must be made to undo the transaction.** Correction means undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.[27] The correction amount must equal the sum of the amount of the excess benefit and interest earned on it. If the excess benefit involved specific property, then the disqualified person may return the specific property previously transferred in the excess benefit transaction, if the tax-exempt organization agrees.

[21] Treas. Reg. § 53.4958-1(d)(3)
[22] Treas. Reg. § 53.4958-1(d)(4)(i)
[23] Treas. Reg. § 53.4958-1(d)(4)(i)(A)
[24] Treas. Reg. § 53.4958-1(d)(4)(i)(B)
[25] Treas. Reg. § 53.4958-1(d)(4)(i)(C)
[26] Treas. Reg. § 53.4958-1(d)(5)
[27] IRC § 4958(f)(6)

If a first-tier tax is imposed on a disqualified person and the transaction is not corrected within the taxable period, then he or she is liable for an additional tax of 200 percent of the excess benefit.[28] In order for the correction to be deemed to have occurred during the taxable period, it must be made before the earlier of [29] the date of mailing a notice of deficiency to the disqualified person for the first-tier tax[30] or the date on which the first-tier tax is assessed.[31]

2. Request an abatement of tax.

a. **Abatement of first-tier tax.** The first-tier tax can be abated if it can be demonstrated to the IRS that the excess benefit transaction was due to reasonable cause, not due to willful neglect,[32] and the transaction was corrected within the correction period.[33] An organization manager's participation is due to reasonable cause if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence.[34] Participation by an organization manager is willful if it is voluntary, conscious, and intentional.[35] The correction period begins on the date the event occurred and ends 90 days after the date of mailing of a notice of deficiency, which includes the imposition of the second-tier **200%** tax on the transaction.[36] This period can be extended if a petition has been filed in Tax Court for a redetermination of the deficiency,[37] or if the IRS determines an extension is reasonable and necessary to bring about correction of the taxable event.[38] If there is an abatement, then any first-tier tax and interest imposed shall not be assessed. If it was assessed, the assessment shall be abated and, if collected, shall be credited or refunded as an overpayment.[39]

b. **Abatement of second-tier tax.** If the excess benefit is corrected during the correction period, then any second-tier tax (200% tax) imposed on the disqualified person (including interest, additions to the tax, and additional

[28] Treas. Reg. § 53.4958-1(a)
[29] Treas. Reg. § 53.4958-1(c)(2)(ii)
[30] Treas. Reg. § 53.4958-1(c)(2)(ii)(A)
[31] Treas. Reg. § 53.4958-1(c)(2)(ii)(B)
[32] I.R.C. § 4962(a)(1), IRC § 4962
[33] I.R.C. § 4962(a)(2)
[34] Treas. Reg. § 53.4958-1(d)(6)
[35] Treas. Reg. § 53.4958-1(d)(5)
[36] I.R.C. § 4963(e)(1)
[37] I.R.C. § 4963(e)(1)(A)
[38] I.R.C. § 4963(e)(1)(B)
[39] I.R.C. § 4962(a)

amounts) shall not be assessed, and if assessed the assessment shall be abated, and if collected shall be credited or refunded as an overpayment.[40]

F. Protective Measures to Prevent an Excess Benefit Transaction

1. **Reliance on Professional Advice.** If full disclosure of the facts of a proposed transaction are made to a professional with expertise in that area, the organization manager will not be treated as knowingly participating in an excess benefit transaction if he or she relied on the professional's reasoned written opinion.[41]

2. **Rebuttable Presumption of Reasonableness**. If organization managers are considering a proposed compensation arrangement or transaction and want to protect themselves from a tax on excess benefit transactions, they can follow a three-step procedure outlined in the regulations,[42] which is often referred to as the "rebuttable presumption of reasonableness." If the following conditions are satisfied, payments under a compensation arrangement are presumed to be reasonable, and a transfer of property, or the right to use property, is presumed to be at fair market value.[43]

   a. The compensation arrangement or the transaction is approved in advance by the governing body or a committee acting on behalf of the governing body and composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement or transaction;[44]

   b. The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination that the compensation arrangement in its entirety is reasonable or the property transfer is at fair market value;[45] and

   c. The authorized body adequately documented the basis for its determination concurrently with making that determination.[46]

   If all three steps are met at the time the parties enter into the contract or transaction,[47] the burden of proof shifts to the IRS to show that the transaction was not reasonable. The IRS may rebut the presumption only if it develops

[40] I.R.C. § 4961(a)
[41] Treas. Reg. § 53.4958-1(d)(4)(iii)
[42] Treas. Regulation §53.4958-6
[43] Treas. Reg. § 53.4958-6(a)
[44] Treas. Reg. § 53.4958-6(a)(1)
[45] Treas. Reg. § 53.4958-6(a)(2)
[46] Treas. Reg. § 53.4958-6(a)(3)
[47] Treas. Reg. § 53.4958-6(f)

sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body.[48]

G. Conclusion

The organization should have a conflict of interest policy. In addition, the organization should provide an annual disclosure for each board member to review the conflict of interest policy and indicate whether any conflicts of interest exist.

The Board of Directors should obtain professional advice prior to making a decision that has the potential to be an excess benefit transaction, and if necessary, request the professional to provide a reasoned written opinion.

When the Board of Directors is contemplating a proposed transaction, they should meet all three steps in order to utilize the rebuttable presumption of reasonableness for their protection.

[48] Treas. Reg. § 53.4958-6(b)

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