

Tax- Exempt Entities: Taxes on Excess Benefit Transactions

In order for a charitable organization to obtain and maintain its tax exempt status, one of the basic requirements is that no part of the organization's net earnings may inure to the benefit of private individuals. Thus, if an exempt charitable organization engages in transactions that confer a personal benefit on directors or other insiders, the IRS may revoke its tax exempt status. In lieu of, or in addition to, revocation of an organization's tax exempt status, the IRS may impose excise taxes on an excess benefit transaction. These excise taxes are referred to as "intermediate sanctions," because they give the IRS a means to penalize private inurement without revoking an organization's tax exemption. The sanctions are more appropriate in instances of relatively minor private inurement. In addition, the taxes serve as a disincentive to the individuals receiving the private inurement because they are required to disgorge the benefit that they received.

Excess Benefit Transactions. The term "excess benefit transaction" refers to any transaction in which a charitable organization provides an economic benefit, directly or indirectly, to or for the use of any disqualified person, so long as the value of the economic benefit exceeds the value of the consideration received by the organization for providing the benefit. The consideration received includes the performance of services by the disqualified person for the organization. The "excess benefit" is the economic benefit provided by the organization over the consideration it receives in exchange. Examples of excess benefit transactions are:

- Payment of excessive compensation to a disqualified person;
- Transfer of an organization's assets to a disqualified person for no consideration, or for inadequate consideration;
- Loans to a disqualified person or to a business owned by a disqualified person where there is a below-market interest rate or where the loans are not repaid in a timely fashion;
- The provision of housing, insurance, or other benefits to a disqualified person if the benefits are not part of a clearly defined and reasonable compensation package; and
- A transaction in which the amount of the economic benefit provided to a disqualified person is determined wholly or partly by the revenues of one or more of the organization's activities, if such revenue-sharing arrangement results in prohibited private inurement.

Tax- Exempt Entities: Taxes on Excess Benefit Transactions (cont.)

Disqualified Persons. The intermediate sanction taxes are imposed only on transactions between an organization and specified disqualified persons. It is therefore critical for an organization to identify its disqualified persons. For any transaction, the term “disqualified person” is defined as:

- Any person who, at any time during the five-year period ending on the date of the transaction, was in a position to exercise substantial influence over the organization’s affairs;
- A member of the family of an insider; or
- An entity controlled by an insider or an insider’s family member.

An individual’s family includes the individual’s spouse and the individual’s ancestors, siblings, children, grandchildren, and great grandchildren, as well as their spouses. Controlled entities include corporations in which insiders (or their family members) own more than 35% of the total combined voting power, partnerships in which insiders (or their family members) own more than 35% of the profits interest, and trusts or estates in which insiders (or their family members) own more than 35% of the beneficial interest.

Notice that the definition of disqualified person includes any person who was an insider during the prior five years. Thus, even if an individual leaves a position of influence within the organization, the threat of intermediate sanctions, and disgorgement of benefits, will follow the individual for a five-year period.

Taxes Imposed. The penalties for engaging in an excess benefit transaction are imposed under a two-tiered tax structure. In the case of any excess benefit transaction, an initial tax is imposed on the disqualified person and, subject to certain limitations, on the organization managers who participated in the transaction. If the disqualified person does not correct the excess benefit transaction within a specified period, the IRS may impose an additional tax.

All disqualified persons involved in the excess benefit transaction are liable for the initial tax equal to 25% of the excess benefit. If the disqualified person does not correct the excess

Tax- Exempt Entities: Taxes on Excess Benefit Transactions (cont.)

benefit transaction within a specified period, the IRS may impose an additional tax equal to 200% of the excess benefit. The IRS has discretionary authority to abate the initial tax if certain requirements are met; however, it must abate the additional tax if the excess benefit transaction is corrected within a specified period.

Under certain circumstances, an organization's manager who participated in an excess benefit transaction is also subject to the initial tax. The initial tax on the organization's manager is equal to 10% of the excess benefit. Organization managers are not subject to the additional 200% tax, and the maximum aggregate amount of all tax collectible as an initial tax from all organization managers on any one excess benefit transaction is limited to \$10,000. The term "organization manager" refers to any of the following persons:

- Any officer, director, or trustee of the organization; or
- Any individual having powers or responsibilities similar to those of officers, directors, or trustees of the organization.
- An initial tax cannot be imposed on an organization manager who participates in an excess benefit transaction unless the following criteria are satisfied:
 - The organization manager participated in the transaction knowing that it was an excess benefit transaction; and
 - The participation of the organization manager was willful and not due to reasonable cause.

As a practical matter, almost any transaction between an exempt organization and a disqualified person is a potential excess benefit transaction. The taxes on excess benefit transactions represent a significant potential liability for an organization's officers, directors, and trustees. However, there are several steps that a charity may take to limit the excess benefit liability. First, it should contact its liability insurance carrier to determine if existing insurance policies provide coverage to officers, directors, and trustees for the excise taxes. Second, the Board of Directors must identify the disqualified persons in the organization at least once a year. Finally, the Board of Directors must carefully review all transactions between the organization and any disqualified persons in order to make use of the rebuttable presumptions for determining the reasonableness of the proposed transaction.

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