INTERMEDIATE SANCTIONS

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INTERMEDIATE SANCTIONS

I. INTRODUCTION

The good news about intermediate sanctions is that they provide the Internal Revenue Service ("IRS") with tools, other than revoking a Section 501(c)(3) organization's exempt status, when a Section 501(c)(3) organization enters into a transaction that may technically jeopardize the organization's exempt status because there has been private inurement to a private individual. Both the IRS and Congress have, and are continuing to pursue the use of, intermediate sanctions in perceived areas of abuse. In 2006, Congress in the Pension Protection Act of 2006 ("Act"), extended the use of intermediate sanctions to Donor Advised Funds ("DAFs").

In March 2007, the Exempt Organizations Office of the Tax Exempt and Government Entities Division ("EO") of the IRS published its "Report on Exempt Organizations Executive Compensation Compliance Project – Parts I and II ("EO Report"). The project was implemented in 2004 and was based on Forms 990 and related returns for tax years beginning in 2002. Although EO had not completed all of the audits it started as a result of the project, as of the date the EO Report was published, the IRS had proposed or assessed excise taxes in excess of $20,000,000 against forty (40) Disqualified Persons or Organization Managers. Thus, the bad news about intermediate sanctions is that if an intermediate sanction is imposed, the cost can be quite high. Accordingly, it is imperative for directors, trustees, officers, substantial contributors, and organization managers of Section 501(c)(3) organizations to know what transactions they may enter into with the Section 501(c)(3) organizations.

The two areas that EO is concentrating on is compensation and loans. Accordingly, while other transactions between Disqualified Persons and Section 501(c)(3) organizations may give rise to intermediate sanctions, the focus of this paper will be the transactions the IRS is focusing on: compensation and loans.

II. BACKGROUND

A. Disallowance of Private Inurement or Benefit

Section 501(c)(3) of the Internal Revenue Code ("Code") provides that one of the conditions for being a Section 501(c)(3) organization is that no part of the net earnings of the organization inures to the benefit of any private individual. For purposes of Section 501(c)(3), the term private individual refers to a person who has a personal or private interest in the organization. The IRS' position is that all persons performing services for a Section 501(c)(3) organization have a personal or private interest in the organization, and, therefore, possess the requisite relationship necessary to find private benefit or inurement. [GCM 36970 (October 19, 1987)].

Reasonable compensation paid to employees does not constitute the inurement of a Section 501(c)(3) organization's earnings to private individuals within the meaning of Section 501(c)(3) of the Code. [Revenue Ruling 73-126, 1973-1 C.B. 220]. Additionally, compensation that is based on a fixed percentage of a department's income will not constitute private inurement if the compensation is arrived at as a result of arm's length negotiations; and the compensation, based on all the facts and circumstances, is reasonable. [Revenue Ruling 69-383, 1969-2 C.B. 113]. Additionally, as to the prohibition on private inurement, the prohibition is aimed at the private inurement to persons who have a personal or private interest in the organization, in other words, insiders. [Announcement 92-83, 1992 I.R.B. 59].

B. EO Report

The EO Report is the EO's published findings from Parts I and II of its Executive Compensation Compliance Initiative Project (the "Project"). A report on Part III is promised. Part III will include two hundred (200) compliance checks and fifty (50) additional single issue examinations focusing on organizations with loans to executives.

Part I of the Project involved the sending of compliance check letters to one thousand twenty three (1,023) public charities and two hundred (200) private foundations. The spectrum of organizations receiving letters included all sizes and different exempt purposes. Churches were not included in the sampling, as they do not have to file Forms 990. The lucky organizations were selected as a result of information reported on their respective Forms 990 and Forms 990-PF. The information on the Form 990 that triggered the selection of the public charities that were contacted was the following: (i) the making of loans in excess of $100,000 to officers, directors, trustees, or key employees; (ii) either reporting "yes" or failing to report whether the organization entered into an excess benefit transaction; and (iii) either reporting "yes" or failing to report whether the organization entered into a transaction with a disqualified person. Another criteria reviewed on the Forms 990 for organizations with assets over $1,000,000 and revenues of at least $5,000,000 was the failure to provide detailed information on compensation, if the compensation paid was significant. As to private foundations, the selection was based on organizations that did not report any officers' compensation.

A major finding from Part I of the Project was that many organizations were confused about completing the Form 990 or 990-PF, or did not understand the instructions. Interestingly, in 2002 the Form 990, not including additional schedules, was six (6) pages and the Form 990-PF was twelve (12) pages. For tax years beginning after 2007 the Form 990 is designed to be more understandable. For 2010, the Form 990 is twelve (12) pages and contains sixteen (16) schedules. The 2010 Form 990-PF is thirteen (13) pages. As to compensation paid to officers and employees, fifty (50) public charities reporting compensation over $250,000 did not initially attach schedules detailing the compensation paid to officers or employees. Neither the Form 990 for 2002, nor the instructions for the Form 990-PF, stated that there was a requirement to attach a statement to the return if compensation paid to an individual exceeds $250,000. The post 2007 Form 990, however, contains a separate schedule that details the information to be provided on executive compensation and compensation paid to highly compensated employees. As a result of the letter sent by EO, forty-one (41) of the public charities filed acceptable amended returns. The other nine (9) public charities were referred for examination. Additionally, twenty (20) private foundations were referred to examination for failure to correctly report compensation paid to officers and other employees.

One finding from Part I of the Project was that there were one hundred (100) public charities that reported loans of over $100,000 to officers, directors, trustees and key employees. After follow-up on this issue, thirty-seven (37) of the public charities were referred for examination. In the private foundation area, there were seven (7) organizations that had made loans to disqualified persons.

Overall, though, forty-nine percent (49%) of the organizations provided clarifying information which resulted in no changes to their Forms 990. As a result of the Part I letters, thirty-one percent (31%) of the organizations filed amended returns. It is interesting to note that it appears that over eighty percent (80%) of the organizations were intent on doing the right thing and complying with the law. Five percent (5%) of the organizations receiving letters were either selected in error or were already under examination. The remaining fifteen percent (15%) of the organizations, based on their responses to the letter, were included in Part II of the Project, the examination.

Part II of the Project involved an examination of seven hundred eighty-two (782) exempt organizations. One hundred small public charities with assets of less than $1,000,000 and revenues of less than $5,000,000 which had reported significant amounts of compensation to at least one officer on Part V of its Form 990 were selected. Two hundred eight (208) large public charities with assets of at least $1,000,000 and revenues of at least $5,000,000 which had reported significant amounts of compensation to at least one officer on Part V of its Form 990 were selected. One hundred ninety-eight (198) private foundations that reported significant officers' compensation on line 13 of Form 990-PF were selected. One-hundred seventy-nine (179) organizations were selected for examination as a result to unsatisfactory responses to the compliance check letters, and ninety-seven (97) public charities were randomly selected by virtue of completing Part V of the Form 990.

Of the seven hundred eighty-two (782) exempt organizations selected for audit, seventy-seven (77) examinations remained open as of the date the EO Report was published. Interestingly, one hundred fifty-six (156) of the selected cases were closed before contact with the exempt organization, as it was determined that the case did not merit examination; and four hundred thirty-four (434) cases that were examined were closed without change. An additional one hundred fifteen (115) cases closed with written advisories to the affected organizations suggesting modifications of behavior. The twenty-five (25) cases that gave rise to the assessment or proposed assessment of excise taxes involved the following issues: (i) excessive salary and incentive compensation; (ii) payments for vacation homes, personal legal fees, and personal automobiles that were not reported as compensation; (iii) payments for personal meals and gifts to others on behalf of a disqualified person that were not reported as compensation; and (iv) payments to an officer's for profit corporation in excess of the value of the services provided by the corporation.

Also, EO concluded that as to public charities fifty-one percent (51%) of the organizations attempted to satisfy the rebuttable presumption test under the Treasury Regulations and that fifty-four percent (54%) of the organizations commissioned comparability studies when setting compensation. Of course, what this means is that almost half of the public charities were failing to take advantage of the rebuttable presumption allowed in the Treasury Regulations.

III. EXECUTIVE COMPENSATION AND LOANS

A. Private Foundations

Section 4941(a)(1) of the Code imposes on each act of self dealing between a disqualified person and a private foundation an excise tax equal to ten percent (10%) of the amount involved. The tax is imposed upon and is to be paid by the disqualified person. Additionally, Section 4941(a)(2) of the Code imposes on any foundation manager a tax equal to five percent (5%) of the amount involved, if the foundation manager participates in an act of self dealing, knowing that the act is one of self-dealing, between a disqualified person and a private foundation. Section 4941(b) of the Code provides that if the act of self dealing is not corrected, the self-dealer may be liable for an additional excise tax equal to two hundred percent (200%) of the amount involved, and the foundation manager may be liable for an additional excise tax equal to fifty percent (50%) of the amount involved.

The term “disqualified person” for purposes of self dealing and private foundations is defined in Section 4946(a)(1) of the Code as follows:

A person who is with respect to the private foundation:

> (A) a substantial contributor to the foundation;
> (B) a foundation manager;
> (C) an owner of more than twenty percent (20%) of:
> > (i) the total combined voting power of a corporation;
> > (ii) the profit’s interest of a partnership; or
> > (iii) the beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the foundation:
>
> (D) a member of the family any person described in (A), (B), or (C);
> (E) a corporation of which persons described above in (A), (B), (C), or (D) own more than thirty-five percent (35%) of the total combined voting power;
> (F) a partnership of which persons described above in (A), (B), (C), or (D) own more than thirty-five percent (35%) of the profits interest; or
> (G) a trust of which persons described above in (A), (B), (C), or (D) hold more than thirty-five percent (35%) of the beneficial interest.

For purposes of applying the self dealing rules for private foundations, the term “foundation manager” means an officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustee of the foundation). [Section 4946(b) of the Code].

For purposes of applying the self dealing rules for private foundations, the term “substantial contributor” means any person who gave more than $5,000 to the private foundation, if such amount is more than two percent (2%) of the total contributions received by the private foundation before the close of the taxable year of the foundation in which the contribution is received. [See Sections 4946(a)(2) and 507(d)(2) of the

Code]. The spouse of a substantial contributor is also treated as a substantial contributor. [Section 507(d)(2)(B)(iii) of the Code]. Once a person becomes a substantial contributor of a private foundation, that person is generally always considered a substantial contributor of that private foundation. [Section 507(d)(2)(B)(iv) of the Code].

Self-dealing includes the payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person. [Section 4941(d)(1)(D) of the Code]. The payment of compensation by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self dealing if the compensation (or payment or reimbursement) is not excessive. [Section 4941(d)(2)(E) of the Code]. Treasury Regulation Section 53.4941(d)-3(c) provides that for purposes of determining whether compensation is excessive, see Treasury Regulation 1.162-7. Unfortunately, Treasury Regulation Section 1.162-7 is not too insightful, as it provides that a deductible ordinary and necessary business expense includes a reasonable allowance for salaries and other compensation for services actually rendered. The test for deductibility is whether the compensation is reasonable.

One reported case, though, in this area that may provide some limited insight is ***Kermit Fischer Foundation***, TC Memo-1990-300. The private foundation in this case had one trustee and for the years in question, 1982 and 1983, the assets did not exceed $211,268. For calendar years 1982 and 1983, the trustee was paid $42,100 and $40,100, respectively. The IRS challenged the reasonableness of the compensation. The IRS' expert testified and submitted a report regarding the usual and customary compensation paid to trustees of private foundations during the years at issue. He reported that for the years at issue most foundations used a formula to determine annual compensation of their trustees. The formula was $4 to $5 per $1,000 of foundation assets plus five percent (5%) of foundation income. Based on this formula, the IRS and the court concluded that reasonable compensation would have been $2,000. Thus, the court concluded that all compensation in excess of $2,000 was unreasonable. Additionally, the court imposed the excise tax under Section 4941.

Self dealing also includes the lending of money or other extension of credit between a private foundation and a disqualified person. [Section 4941(d)(1)(B) of the Code]. However, the lending of money by a disqualified person to a private foundation shall not be an act of self dealing if the loan is without interest or other charge and if proceeds of the loan are used exclusively for purposes specified in Section 501(c)(3) of the Code. [Section 4941(d)(2)(B) of the Code]. [For a full list of all the acts of self dealing between a private foundation and a disqualified person see Section 4941(d) of the Code].

B. <u>Public Charities</u>

Section 4958(a) of the Code provides that a twenty-five percent (25%) excise tax is imposed on each "disqualified person" and a ten percent (10%) excise tax is imposed on any organization manager who knowingly is involved in or approves an "excess benefit transaction." If the excess benefit transaction is not corrected, a tax equal to two hundred percent (200%) of the excess benefit is also imposed on the disqualified person.

For purposes of Section 4958 of the Code a "disqualified person" includes the following:

(A) any person who was at any time during the last five years preceding the date of the transaction in a position to exercise substantial influence over the affairs of the organization;
(B) a member of the family of any person described in A; and
(C) a thirty-five percent (35%) controlled entity.
[Section 4958(f)(1) of the Code].

Persons who have substantial influence over the affairs of the organization include the following:

(A) Voting members of the governing board;
(B) Presidents, chief executive officers, and chief operating officers; and
(C) Treasurers and chief financial officers.
[Treasury Regulation Section 53.4958-3(c)].

For purposes of Section 4958 of the Code the term "organization manager" means 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. [Section 4958(f)(2) of the Code].

An “excess benefit transaction” is any transaction in which an “excess benefit” is received by a disqualified person from a public charity. “An excess benefit” occurs if the value of the benefit received by the “disqualified person” exceeds the value of the consideration (including the performance of services) given by the “disqualified person” to the public charity. An economic benefit received for the performance of services, however, will not be treated as compensation in exchange for the performance of services unless the organization clearly indicated that it intended to treat the economic benefit as compensation for the services rendered. [Section 4958(c)(1)(A) of the Code]. The intent that must be provided by the organization to show that the benefit was in exchange for the services provided is “written substantiation that is contemporaneous with the transfer of the economic benefit.” [Treasury Regulation Section (“Treas. Reg. Sec.”) 53.4958-4(c)(1)]. The contemporaneous substantiation requirement can be satisfied by the organization providing a Form W-2 or Form 1099 to the service provider or by disclosing the payment on the organization’s Form 990. Additionally, the contemporaneous substantiation requirement can be satisfied by having an approved, written contract in effect prior to the payment of the benefit. [Treas. Reg. Sec. 53.4958-4(c)(3)]. If the benefit that is being provided is a benefit that would be excluded from the service provider’s gross income, then the intent to provide the benefit would not have to satisfy the substantiation requirements (i.e., employer provided health benefits). [Treas. Reg. Sec. 53.4958-4(c)(2)]. For audit purposes, the IRS’ position is that if there is not a contemporaneous written instrument that substantiates the intent of the organization to treat the benefit as compensation for services, the compensation paid is an “automatic” excess benefit transaction. [See IRS’ 2004 EO CPE Text “Automatic” Excess Benefit Transactions under IRC 4958 by Lawrence M. Brauer and Leonard J. Henzke, Jr. (“AEBT Paper”) Page 2].

Even if the contemporaneous substantiation requirement is satisfied, the compensation will still be treated as an excess benefit unless the compensation is "reasonable." Treasury Regulation Section 53.4958-4(b)(1)(ii) provides that reasonable compensation is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances. Treasury Regulation Section 53.4958-4(b)(2)(i) provides that facts and circumstances to be taken into account for determining the reasonableness of a fixed payment are those existing at the date the parties enter into the contract. Treasury Regulation Section 53.4958-4(b)(2)(i) provides that facts and circumstances to be taken into account for determining the reasonableness of a non-fixed payment are those existing up to and including the date of payment. A fixed payment is a payment that is paid pursuant to a fixed formula. [Treas. Reg. Sec. 53.4958-4(a)(3)(ii)]. A non-fixed payment is a payment that is not paid pursuant to a fixed formula. [See Treas. Reg. Sec. 53.4958-4(a)(3)(ii) and Treas. Reg. Sec. 53.4958-4(a)(3)(vi)]. An agreement can provide for both a fixed payment amount and a non-fixed payment amount. [See Treas. Reg. Sec. 53.4958-4(a)(3)(vii) Example 2].

Treasury Regulation Section 53.4958-6 in fact provides that payments under a compensation arrangement are presumed to be reasonable (i.e., not excessive) if the following conditions are satisfied:

1. The compensation arrangement is approved in advance by an authorized board comprised entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement.
2. The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination.
3. The authorized body adequately documented the basis for its determination concurrently with making the determination.

As to the first requirement, a "disqualified" director would not be a member of the authorized body for purposes of approving the arrangement, if the person recuses himself from the meeting, and is not present during the debate, and the voting on the compensation arrangement. [Treas. Reg. Sec. 53.4958-6(c)(1)(ii)]. Note that this requirement is more stringent than merely abstaining from the vote.

As to the second requirement, the governing body, based on its knowledge and expertise, must be given sufficient information upon which it can determine whether the compensation is reasonable, as provided under Treasury Regulation Section 53.4958-4(b). Relevant information includes the following: compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the public charity; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person. Note, there is no explicit requirement that bids be obtained from other persons. In examples in the Treasury Regulations, the IRS points out that in comparing survey data, the data has to be based on like institutions. The IRS points out that a compensation survey for presidents at universities that stated the range in salaries was \$100x to \$700x was not adequate for awarding a university president a salary of \$600x when there was no indication as to how salaries compared based on revenues, student size, or geographic location.

Additionally, in "Rebuttable Presumption Procedure is a Key to Easy Intermediate Sanctions Compliance" by Steven T. Miller, Director Exempt Organizations, IRS, Mr. Miller gave his views as to what data should be used. Mr. Miller stated as follows:

> The comparability data may be based on industry surveys, documented compensation of persons holding similar positions in similar organizations, expert compensation studies, or other comparable data. Organizations with gross receipts of less than \$1 million per year only need compensation data for three similar positions in similar communities. For other organizations, the Regulations do not specify the number of comparables or comparability sources required. Data may be obtained by any means, including documented phone calls.

As to the third requirement, minutes must be produced from the meeting that contain the following information: (i) the terms of the arrangement that was approved; (ii) the names of the persons who attended the meeting; (iii) the comparability data obtained and relied upon by the body, and how the data was obtained; and (iv) the fact that the "disqualified" person was not present during the discussion or vote on the arrangement. The minutes must be prepared no later than the earlier of: (i) the next meeting of the board; or (ii) sixty (60) days after the meeting at which the compensation was approved. The minutes must then be approved by the board within a reasonable period of time after the minutes are prepared. [Treas. Reg. Section 53.4958-6(c)(3)].

It is important to note that although it is preferable to satisfy the requirements of Treasury Regulation Section 53.4958-6, the fact that the requirements are not satisfied does not necessarily mean that the compensation paid to a disqualified person is an excess benefit. [See "Easier Compliance is Goal of New Intermediate Sanction Regulations" by Steven T. Miller, Director of Exempt Organizations, Internal Revenue Service]. The effect of not satisfying Treasury Regulation Section 53.4958-6 is that you lose the presumption of reasonableness.

Also, any loan between a public charity and a disqualified person constitutes an excess benefit transaction if the transaction results in an excess benefit to the disqualified person. [Section 4958(c)(1)(A)]. As to loans, the IRS has determined that the loan will result in an excess benefit to a disqualified person if the interest payment to be paid by the public charity to the disqualified person exceeds the market rate. [See PLR 200822039]. In Private Letter Ruling 200822039 the IRS based market rate on the Applicable Federal Rates that are published monthly by the IRS.

C. <u>Special Concerns with Non-Qualified Deferred Compensation</u>

Extreme care needs to be taken any time the recommendation is made to give an employee of a tax-exempt organization non-qualified deferred compensation. The general rules that apply to non-qualified deferred compensation in the for-profit world do not apply to non-qualified deferred compensation in the tax-exempt world. The reason for this is that in the for profit arena, there is a perceived balancing. That balancing is that the employer does not receive a tax deduction for the deferred compensation set aside for an employee until the tax year the employee actually or constructively receives the income. In the tax exempt area, though, the employer generally does not benefit from tax deductions, so there is no incentive for the tax exempt employer to accelerate the distribution of the deferred compensation. Consequently, Section 457(f) of the Code provides that in the case of tax exempt employers, deferred compensation is included in an employee's income in the taxable year in which there is no substantial risk of forfeiture to the rights of such compensation. The definition of "substantial risk of forfeiture" means that the employee's rights to the compensation is conditioned on the future performance of services by the employee. [Section 457(f)(3) of the Code]. Thus, in the non-profit world, once an employee's right to the compensation vests, even if the compensation is not paid or made available to the employee until sometime in the future, the employee must include the deferred compensation in income.

Contributions made by tax-exempt employers to Section 403(b) arrangements are exempt from the harsh rules of Section 457(f) of the Code. [Section 457(f)(2) of the Code].

Section 457(f)(1)(B) of the Code provides that the amount made available to an employee under a Section 457(f) arrangement shall be determined under Section 72 of the Code. Section 72(a) of the Code provides the general rule that gross income includes the amount received as an annuity. Section 72(b) of the Code, however, provides that gross income does not include that portion of an annuity payment that represents the recipient's "investment in the contract." As a general rule, the term "investment in the contract" means the premiums paid for the annuity (See Section 72(c)). Section 72(f) of the Code provides that the term "investment in the contract" includes amounts contributed to the contract by an employee's employer but only to the extent that "such amounts were includible in the gross income of the employee."

Treasury Regulation Section 1.457-11(a)(3) provides that earnings earned on the deferred compensation after the deferred compensation has been includible in the employee's gross income are includible in income in the year the earnings are paid or made available to the employee.

Thus, under Section 457(f) contributions to a deferred compensation arrangement are taxed in the year the contributions are made, provided the employee's right to the contributions are not contingent on something happening in the future, such as the employee having to work for the employer for a number of years. If the contributions are contingent on the employee having to work for a number of years, the contributions and any earnings on the contributions should be included in the employee's income when the employee satisfies the service requirement. Earnings that accrue in tax years after the employee's right to the contribution vests are taxable as annuity income to the employee when the funds are actually distributed to the employee.

Additionally, although compensation may be deferred, deferred compensation is still subject to the rules under Section 4958 concerning contemporaneous substantiation and reasonableness. [See IRS 2003 EO CPE Text "Intermediate Sanctions (IRC 4958) Update" by Lawrence M. Brauer and Leonard J. Henzke ("Intermediate Sanctions") Page E-28]. If deferred compensation results in an "excess benefit," the payment of the excess benefit occurs in the first to occur: (i) the year the deferred compensation is no longer subject to a substantial risk of forfeiture; or (ii) the year the payment is received. [See Intermediate Sanctions p. E-28]. The following example provided in Intermediate Sanctions provides guidance on how the IRS reviews deferred compensation arrangements provided by tax-exempt employers:

> Effective January 1, 1996 EO employed C as President for five years. C is a disqualified person. In exchange for the services C was to provide, EO agreed to pay C the following salary

1996	$	200,000
1997	$	250,000
1998	$	300,000
1999	$	350,000
2000	$	400,000
TOTAL	$	1,500,000

> Also effective January 1, 1996 EO and C entered into a deferred compensation arrangement. The deferred compensation arrangement provided for the payment of $1,000,000 if C completed the five year term. C completed the five year contract and was paid $1,000,000 on January 1, 2001.

> The example provides that to determine if any of the $1,000,000 was an excess benefit it was necessary to look at the actual compensation received for each of the five years and the Deemed Compensation earned during those years. The analysis was conducted as follows and reached the following conclusion:

Year	Actual	Deemed	Aggregate	Fair Value	Excess
1996	$200,000	$200,000	$400,000	$250,000	$150,000
1997	$250,000	$200,000	$450,000	$300,000	$150,000
1998	$300,000	$200,000	$500,000	$350,000	$150,000
1999	$350,000	$200,000	$550,000	$400,000	$150,000
2000	$400,000	$200,000	$600,000	$450,000	$150,000
Total		$1,000,000			$750,000

> The conclusion is that in each year C had an excess benefit. However, the deferred or deemed compensation did not vest until the completion of the fifth year. Thus, on January 1, 2001, when C received the deferred compensation payment of $1,000,000, C also received an excess benefit of $750,000.
> [See Intermediate Sanctions pp E29-E31 and Treas. Reg. Sec. 53.4958-1(e)].

D. <u>Special Concerns with Expense Payments or Reimbursements</u>

Another area of concern is expense reimbursements to executives, and other disqualified persons providing services to the tax-exempt organization. On the one hand, this should not be of major concern because Treasury Regulation Section 53.4958-4(a)(4)(ii) explicitly provides that expense reimbursements paid under an account reimbursement plan that satisfies the requirements of Treasury Regulation 1.62-2(c) are not treated as excess benefits. However, if an organization fails to maintain an account reimbursement plan or fails to obtain the documentation needed to substantiate the business purpose of a reimbursed expense to a disqualified person, the payment on behalf of the disqualified person will result in an excess benefit transaction.

In a number of Technical Advice Memoranda ("TAMS") and Private Letter Rulings ("PLRs") the IRS has demonstrated that it is intent on the imposition of the excise taxes under Section 4958. Technical Advice Memoranda, TAMS 200435018, 200425019, 200435020, 200435021, and 200435022 involved one charitable organization that had engaged in a number of excess benefit transactions with a number of disqualified persons. As to each disqualified person, the IRS found that expenses that were either paid for or reimbursed to the disqualified person were not supported by the required documentation needed to exempt the payment or reimbursement from being treated as an excess benefit. The consequence of the IRS' findings was that each payment or reimbursement resulted in an excess benefit that was subject to both the tier one, twenty-five percent (25%) tax, and the tier two, two hundred percent (200%) tax.

The questionable expenses and the disqualified persons included the following:

1. The son of the organization's founder – exclusive use of a truck (TAM 200435018);
2. The son of the organization's founder and a director of the organization – unsubstantiated expenses charged to the organization's gas credit cards and travel expenditures (TAM 200435019);
3. The founder and president of the organization – unsubstantiated expenses charged on the organization's gas credit cards and other credit cards (TAM 200435020);
4. The wife of the founder – unsubstantiated expenses charged to the organization's credit cards for meals, gasoline, and miscellaneous expenditures (TAM 200435021); and
5. The son of the organization's founder and a director of the organization – unsubstantiated expenses charged to the organization's gas credit cards and travel expenditures (TAM 200435022).

The IRS' rationale in each of the TAMS in which an expense reimbursement was found to be an excess benefit was as follows:

> Section 53.4958-4(a)(4) of the Federal Income Tax Regulations provides that certain economic benefits are disregarded for purposes of section 4958, including….expense reimbursement repayments pursuant to an accountable plan that meets the requirements of section 1.62-2(c) and sections 53.4958(4)(a)(4)(i) and (ii) of the regulations.
>
> Section 1.62-2(c)(1) of the regulations provides that an accountable plan must meet the business connection, substantiation, and returning-excess-payments provisions of the regulation.

Section 1.62-2(d)(1) of the regulations provides that expenses reimbursable under an accountable plan must constitute deductible business expenses under section 162 or other business deduction statutes.

Section 1.62-2(e)(1) provides that expense reimbursements under an accountable plan must satisfy the substantiation rules of sections 1.162-17 or 1.274-5T of the regulations.

Section 162 of the Code provides in part that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including, (1) a reasonable allowance for salaries or other compensation for personal services rendered; (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business….

Section 1.274-5T(b) of the regulations requires each employee to provide substantiation of the business purpose of each expense, generally in writing. Section 1.274-5T(b)(2) of the regulations provides that no deduction or credit shall be allowed for travel unless the taxpayer substantiates the following elements: (1) Amount - amount of each separate expenditure for traveling away from home; (2) Time - dates of departure and return for each trip away from home and number of days away from home spent on business; (3) Places - destinations or locality of travel and (4) Business purpose - business reason for travel or nature of the business benefit derived as a result of the travel...

Section 1.274-5T(c)(2)(i) of the regulations states that a taxpayer, to meet the "adequate records" requirements of section 274(d), shall maintain an account book, diary, statement of expense or similar record and documentary evidence which, in combination, are sufficient to establish each element of an expenditure. Section 1.274-5T(c)(2)(ii) of the regulations states that the account book, diary, statement of expense or similar record must be prepared or maintained in such manner that each recording of an element of an expenditure is made at or near the time of the expenditure.

Section 1.274-5T(c)(2)(iii), and for periods after January 20, 2000, section 1.274-5(c)(2)(ii) of the regulations requires the employee to maintain documentary evidence, such as receipts, paid bills, or similar evidence….

> Section 53.4958-4(c)(1) of the Foundation and Similar Excise Taxes Regulations provides that an economic benefit is not treated as consideration for the performance of services (i.e., compensation) unless the organization providing the benefit clearly indicates its intent to treat the benefit as compensation when the benefit is paid. If an organization fails to provide contemporaneous substantiation of such intent, 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. If the substantiation requirement is not satisfied, then the value of the benefit will be treated as an automatic excess benefit taxable under Code 4958 (a). [See PLRS 200435018, 200425019, 200435020, 200435021, 200435022].

As stated above, the reason for enacting the intermediate sanctions was to provide the IRS with a tool other than revocation in those instances when a private inurement occurred but based on all the facts and circumstances the private inurement was not so egregious as to warrant the revocation of the organization's tax-exempt status. However, some of the facts that the IRS takes into consideration in determining whether the intermediate sanctions are sufficient punishment are the actions taken by the tax-exempt organization after an excess benefit transaction has occurred. Two factors that are important to the IRS in making a determination as to whether the intermediate sanctions are sufficient are what steps the organization took to correct the excess benefit transaction and what steps the organization took to prevent future excess benefit transactions. The IRS' position on steps to take following the occurrence of an excess benefit transaction are exemplified in two 2008 Private Letter Rulings.

The tax-exempt organization in PLR 200801040 provided in its articles of incorporation that its purpose was "exclusively religious, charitable, scientific, literary, and educational within the meaning of section 501 (c)(3)." The organization held a ten day film festival each year promoting foreign language films. The founder of the organization, Mr. Founder, incurred travel expenses during the years under examination that were paid by the organization. The travel expenses were for trips to cities in the United States, Spain, and Canada to attend film festivals and meet with producers and directors to secure films for organization's film festival. The organization also paid for Mr. Founder's personal expenses including meals. The organization's board of directors had four members, Mr. Founder, Mr. Founder's wife, and two other individuals. The IRS in reviewing the travel expenses, discovered that the organization did not maintain any airline tickets, receipts or correspondence confirming the business purpose of the travel and that the organization did not maintain an accountable plan.

In ruling that the organization had engaged in a number of excess benefit transactions and that the organization's tax-exempt status should be revoked, the IRS stated as follows:

> ORG 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 ORG collectively are significant in relation to the size and scope of ORG's activities that further exempt purposes. Moreover, ORG has been involved in repeated excess benefit transactions. ORG has not implemented any safeguards that are reasonably calculated to prevent future diversions. The excess benefit transactions have not been corrected, nor has ORG made good faith effort to seek correction from Mr. Founder, the disqualified person who benefited from the excess benefit transactions. Based on the application of the factors to these facts, ORG is no longer described in section 501(c)(3) effective Date 1.

The tax-exempt organization in PLR 200829049 provided in its articles of incorporation that its purpose was "to aid the poor and disadvantaged individuals and families towards a life of self-sufficiency." On the Form 1023 that the organization filed to obtain its tax-exempt status the organization represented that its initial activities would consist of prison outreach and youth drug prevention. The purpose of the PLR was to advise the tax-exempt organization that the IRS was revoking the organization's tax-exempt status. The review of the organization's tax-exempt status arose out of an audit conducted by the IRS of the organization's Founder/Executive Director's individual income tax return, Form 1040. On the Form 1040, the Founder/Executive Director filed a Schedule C on which he listed the tax-exempt organization as his personal business. During the audit the IRS reviewed the payment of the Founder/Executive Director's travel expenses. The Founder/Executive Director traveled to different cities to obtain information on how to take the organization to another level. However, as to the travel expenses, the organization did not maintain any airline tickets, receipts, or correspondence confirming the business purpose of the trips. The organization also acknowledged that it did not maintain an accountable plan. In addition to the undocumented travel expenses, the organization paid some of the Founder/Executive Director's personal expenses. Finally, the examination revealed that the organization had a five member board of directors in name only, and that the board did not exercise any oversight over the organization. In ruling that the organization had engaged in a number of excess benefit transactions and that the organization's tax-exempt status should be revoked, the IRS stated as follows:

> ORG 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 ORG beginning in 20XX collectively are significant in relation to the size and scope of ORG's activities that further exempt purposes. Moreover, ORG has been involved in repeated excess benefit transactions. ORG has not implemented any safeguards that are reasonably calculated to prevent future diversions. The excess benefit transactions have not been corrected, nor has ORG made good faith effort to seek correction from BM-1, [Founder/Executive Director] the disqualified person who benefited from the excess benefit transactions. Based on the application of the factors to these facts, ORG is no longer described in section 501(c)(3) effective January 1, 20XX.

IV. DONOR ADVISED FUNDS (DAFs)

A. The Act

Prior to the Act there was no specific tax legislation regarding DAFs. However, as donors retained the ability to provide nonbinding guidance as to the investment of and distribution from DAFs, there was the perception that this area may be ripe for abuse. The Act provides a statutory definition of a DAF and provides the imposition for certain sanctions involving DAFs. Additionally, Congress instructed the IRS to provide to Congress by August 17, 2007 a study on DAFs addressing the following issues: (i) whether the amount and availability of income, gift, and estate tax charitable deductions allowed for charitable contributions to sponsoring organizations of DAFs is appropriate in consideration of the use of the assets or the use of the assets of such organization for the benefit of the person making the charitable contribution; (ii) whether DAFs should be required to distribute for charitable purposes a specified amount in order to ensure the sponsoring organization with respect to the fund is operating consistent with the purposes or functions constituting the basis for its exemption under Section 501; and (iii) whether the retention by donors to DAFs of rights or privileges with respect to the making of grants or the investment of assets is consistent with the treatment of such transfers as completed gifts that qualify for the charitable deduction. [Section 1226 of the Act]. To date, if the IRS did comply with Congress' August 17, 2007 deadline, the study has not been made public.

B. What is a DAF?

A DAF is defined in Section 4966(d)(2) of the Code to mean a fund that is:

(i) separately identified by reference to contributions of a donor or donors;

(ii) owned and controlled by a sponsoring organization; and

(iii) with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor.

The term sponsoring organization is defined in Code Section 4966(d)(1) as an organization defined in Section 170(c) of the Code other than a governmental entity or a private foundation and that maintains at least one donor advised fund. In other words, a public charity generally qualifies as a sponsoring organization.

In determining whether a donor has or reasonably expects to have advisory powers it is important that the advisory powers be obtained or be expected to be obtained as a result of the donor's status as a donor. For instance, if the donor reasonably expects to have advisory powers because the donor is an officer, employee, or director of the sponsoring organization, then the third requirement for being a DAF is not satisfied. However, if as a result of a particular donation, the donor obtains a position on a committee that will make decisions concerning the distribution or investment of the funds, then the fund may be a DAF. [See page 344 of the Joint Committee on Taxation Technical Explanation of the Act].

Additionally, two types of funds are specifically excluded from the definition of a DAF. The first type of fund that is excluded from being treated as a DAF is a fund which provides distributions to a single identified organization or governmental entity. [Section 4966(d)(2)(B) of the Code]. The second exception is for scholarship funds, provided certain conditions are satisfied. [Section 4966(d)(2)(B)(ii) of the Code]. The conditions are the following:

(i) the donor's advisory privileges are performed exclusively by the donor in the donor's capacity as a member of a committee all of the members of which are appointed by the sponsoring organization (i.e., the public charity);

(ii) the donor, or persons appointed or designated by the donor or persons related to the donor or persons designated or appointed by the donor do not control, directly or indirectly, the scholarship selection committee; and

(iii) all grants from the account or fund are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the board of directors of the sponsoring organization (i.e., the public charity's Board of Directors), and such procedure is designed to ensure that the grant qualifies as a scholarship under Section 117(a) of the Code and is to be used at an educational institution described in Section 170(b)(1)(A)(ii) of the Code (i.e. established colleges, and universities).

C. <u>What Restrictions are Placed on a DAF</u>?

1. <u>Excise Tax on Taxable Distributions</u>

"Taxable distributions" from DAFs are subject to an excise tax. [Section 4966(a)(1) of the Code]. The amount of the excise tax is an amount equal to twenty percent (20%) of the amount of the taxable distribution. Additionally, a five percent (5%) excise tax may be imposed on a fund manager who knowingly makes a taxable distribution. As a general rule, the term "fund manager" means an officer, director, or trustee of the sponsoring organization. [Section 4966(d)(3) of the Code].

A "taxable distribution" is any distribution from a DAF that is made to (A) a natural person or (B) to any other person if (i) such distribution is for any purpose other than a purpose specified in Section 170(c)(2)(B) of the Code; or (ii) the sponsoring organization does not exercise expenditure responsibility with respect to such distribution in accordance with Section 4945(h) of the Code. [Section 4966(c)(1) of the Code]. The purposes specified in Section 170(c)(2)(B) of the Code are the following: religious; charitable; scientific; educational; fostering national or international amateur sports competition; and the prevention of cruelty to children and animals. The expenditure authority required under Section 4945(h) is the establishment of adequate procedures to (i) see that the grant is spent solely for the purpose for which it is made; (ii) obtain full and complete reports from the grantee on how the funds were spent; and (iii) make full and detailed reports with respect to such expenditures to the IRS.

The term "other person" includes the following: (i) a trust; (ii) an estate; (iii) a partnership; (iv) an association; (v) a company; or (vi) a corporation. [Section 7701(a)(1) of the Code].

The term taxable distribution generally does not mean a distribution to another organization that qualifies as a Section 501(c)(3) organization. [See Section 4966(c)(2) of the Code].

2. <u>Excise Tax on Prohibited Benefits</u>

If a benefit is received by a donor, a member of the donor's family, or an entity controlled by the donor as a result of the advice provided by the donor, member of the donor's family, or an entity controlled by the donor, an excise tax equal to one hundred twenty five (125%) percent of the benefit received will be imposed on the persons receiving the benefit. [Section 4967 of the Code].

3. <u>Excise Tax on Excess Benefit</u>

In addition to the taxes imposed under Sections 4966 and 4967, if an excess benefit is received by a disqualified person from a DAF, the taxes imposed under Section 4958 of the Code on disqualified persons and organization managers may be assessed. For purposes of DAFs, the term "excess benefit transaction" includes any grant, loan, compensation or other similar payment from the DAF to a disqualified person. [Section 4958(c)(2)(A) of the Code]. For purposes of DAFs, the term "excess benefit" means the amount of the grant, loan, compensation or other similar payment that is the subject of the excess benefit transaction. [Section 4958(c)(2)(B) of the Code]. For purposes of DAFs and excess benefit transactions, the term "disqualified person" means the following:

(i) the donor or any person appointed or designated by the donor who has or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the DAF;

(ii) a member of the family of a person described in (i); and

(iii) a thirty-five percent (35%) controlled entity of persons described in (i) and (ii).

[Section 4958(f)(7) of the Code].

V. PENALTY ASSESSED ON INTERMEDIATE SANCTIONS

As mentioned above, a number of taxes may be assessed in the case of an act of self dealing in the private foundation area and in the case of an excess benefit transaction in the public charity area. There are the initial or tier one taxes that are imposed if there has been an act of self dealing or the occurrence of an excess benefit transaction. If the act of self dealing or the excess benefit transaction is not corrected, there is the tier two tax. In both the private foundation and the public charity area if the prohibited act is not corrected the taxes paid can exceed the value of the transaction.

In addition to the excise taxes on intermediate sanctions under Sections 4941 and 4958, a person may also be subject to an additional penalty under Section 6684 of the Code. Section 6684 provides that if a person is liable for a tax under Section 4941 or 4958 by reason of any act or failure to act which is not due to reasonable cause and either (i) such person has been liable for tax under Section 4941 or 4958; or (ii) such act or failure to act is both willful or flagrant then such person shall be liable for a penalty equal to the amount of such tax.

An example of how the taxes can result in a compounding effect is provided in TAM 200243057. In that TAM, B was the former President, Executive Director and founder of the tax-exempt organization. The original board of directors of the organization consisted of B, B's wife, B's father-in-law, and a CPA. The purpose of the organization was to allow individuals to donate their used vehicles for a tax deduction and to choose the charity to which they wanted the sale proceeds from the vehicle sales to be given. The organization was incorporated in 1998. The CPA resigned from the board in November of 1998 after informing B that thirteen checks he reviewed were enough to cause the organization to lose its tax-exempt status. Two months before the IRS began its audit of the organization, B resigned as president and executive director of the organization and disbanded the board. The new board of directors, while not family members of B, were either employees of the organization or had a financial arrangement with the organization. In auditing the organization, some of the rulings made by the IRS were as follows:

1. B as the founder, president, and executive director was a disqualified person as to the organization.
2. B as an officer and director of the organization was an organization manager.
3. The salary paid to B in 1998 and 1999 was presumptively an excess benefit as there was no documentation as to the hours B worked, the services provided, comparable salaries for similar service, and no board minutes authorizing the payment of the salary.
4. The severance pay paid to B in 2000 was an excess benefit as there was no evidence of a severance agreement and the new board of directors had knowledge of improper payments made by the organization to B.
5. B as an organization manager willfully authorized the organization to engage in excess benefit transactions with himself and therefore is liable for the excise tax imposed on organization managers under Section 4958.
6. B is subject to the penalty under Section 6684 because B continued to engage in excess benefit transactions even after he was informed by a CPA that the transactions were prohibited. Therefore his actions in continuing to engage in such transactions were not based on reasonable cause.

Thus, as an organization manager B was subject to an excise tax equal to ten percent (10%) of the value of the excess benefit transaction. B was also subject to a penalty equal to the amount of the excise tax. Thus, in his capacity as an organization manager B was subject to a liability equal to twenty percent (20%) of the value of the excess benefit transaction.

B, though, was also subject to the two taxes under Section 4958 in his capacity as the disqualified person. The amount of the two taxes would be two hundred and twenty-five percent (225%) of the value of the excess benefit transaction.

Next, B was also subject to a penalty under Section 6684 which is an amount equal to the excise tax. Thus, in his capacity as a disqualified person B is subject to a liability equal to four hundred and fifty percent (450%) of the value of the excess benefit transaction.

Accordingly, since B was both an organization manager and a disqualified person, B's liability would be four hundred and seventy percent (470%) of the value of the excess benefit.

VI. <u>REPORTING AND CORRECTING SELF DEALING AND EXCESS BENEFIT TRANSACTIONS</u>

Private foundations are required to report any acts of self dealing in Part VIIB of the Form 990-PF. Public Charities are required to report any excess benefit transactions in Part IV of Form 990 and on Schedule L of Form 990. Additionally, on Form 990, Schedule L, a public charity is required to report as to whether the excess benefit transaction has been corrected.

Treasury Regulation Section 53.4958-7(a) provides the general rule that an excess benefit transaction is corrected by undoing the excess benefit to the extent possible and taking any additional measures necessary to place the tax-exempt organization in a financial position that is not worse than the financial position the tax-exempt organization would have been in had the disqualified person been dealing under the highest fiduciary standards. Also, as a general rule, the correction is done by the disqualified person making a payment in cash or cash equivalents to the tax-exempt organization equal to the correction amount. [Treas. Reg. Sec. 53.4958-7(b)]. The correction amount is the sum of the excess benefit plus interest on the excess benefit. The interest is calculated from the date the excess benefit transaction occurred to the date the correction is made. The interest rate is the Applicable Federal Rate compounded annually for the month in which the excess benefit transaction occurred. The determination as to whether the short term, mid-term or long term rate is to be used is dependent on the time that elapsed between the occurrence of the excess benefit transaction and the date of the correction. [Treas. Reg. Sec. 53.4958-7(c)].

The tier one tax imposed on acts of self dealing or excess benefit transactions is reported on Form 4720. If the tax-exempt organization and the disqualified person have the same tax year, then both the organization and the disqualified person can sign the Form 4720. The payment for the tax imposed on the disqualified person would accompany the Form 4720 in the form of a check written on the disqualified person's checking account. If the tax-exempt organization and the disqualified person have different tax years, then a Form 4720 must be filed by the tax-exempt organization for its tax year and for the disqualified person for his tax year. [See 2010 IRS Instructions for Form 4720, page 2].

VII. SUMMARY

As mentioned at the beginning of this paper, Congress and the IRS are intent on curbing perceived abuses in the exempt organization arena. This paper touched on the transactions that appear to be under the most scrutiny by the government. Persons who are disqualified persons or who are organization or foundation managers should be careful to make sure that any transactions between the disqualified person and the organization are not in violation of any of the rules set forth above. Also as evidenced by the TAMs and PLRs issued during the past few years and the increased information required to be reported about excess benefit transactions on the Form 990-PF and the Form 990 and Schedule L, tax-exempt organizations that have been involved in self dealing or excess benefit transactions should correct the prohibited transaction as soon as possible.

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