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Filer Beware

Excess benefit transactions and the revised Form 990

The revised federal Form 990 greatly expands the scope of disclosures required by tax-exempt organizations. The new form is forcing many organizations to take a closer look at which transactions they need to report, how much information must be included, and what steps they can take to avoid scrutiny by the Internal Revenue Service (IRS).

Among other things, the new disclosures have created real concern that the IRS will use the information provided to decide that charities have engaged, even inadvertently, in an excess benefit transaction (EBT) with an insider. The potential consequences of engaging in these types of transactions are significant.

If the IRS determines that an EBT has occurred, the insider who received the benefit and any organization managers who approved the benefit might be subject to financial penalties under the Intermediate Sanctions rules that apply to charities. More significantly, engaging in the transaction might jeopardize the organization's tax-exempt status.

EXCESS BENEFIT TRANSACTIONS AND THE LAW

Organizations that are exempt from federal income tax under Sections 501(c)(3) and (c)(4) of the Internal Revenue Code are prohibited from engaging in EBTs, which are defined as transactions in which an organization directly or indirectly provides a "disqualified person" with an economic benefit that exceeds the value of the corresponding benefit received by the organization.

Disqualified persons are generally those who are in a position to exercise substantial influence, such as key employees, officers, and directors, their family members, and certain organizations controlled by those individuals. The revised 990's EBT disclosures require listing any instances of overpayment, and stating whether the transaction was corrected.

EBTs are part of a broader IRS prohibition against private benefit, which generally prohibits insiders and non-insiders from receiving a benefit from a tax-exempt organization. Managers should also be aware that transactions providing more

than an insubstantial private benefit to any third party could also put the organization's tax-exempt status at risk.

EBTs can occur in a variety of circumstances. The most common EBT is a payment or benefit given to a management-level employee that is not reported as taxable income or taken into account during the organization's review of the employee's compensation package.

Other types of EBTs might occur in instances where the organization pays compensation that exceeds the fair market value of the services provided or confers other perquisites, such as free housing that is provided for the convenience of the employee, rather than the organization. Payment of travel expenses for a spouse or companion whose presence does not sufficiently help the organization accomplish its exempt purposes would also constitute an EBT.

The revised Form 990, effective for 2008 and later tax years, contains a number of questions designed to identify EBTs, particularly in the sections related to governance, compensation, and interested party transaction reporting. All of this new information will be readily available to the IRS and, because the 990 is a public document, to the public at large.

COMPENSATION

Exempt organizations' executive compensation practices have long been an area of focus for the IRS and the public alike. With the revised 990's increased disclosures on this topic and the threat of Intermediate Sanctions looming in the background, organizations are being forced to become familiar with the requirements and come into compliance before an inadvertent disclosure creates potentially troublesome public relations and tax penalty dilemmas.

The core form's compensation disclosures require reporting on current officers, directors, and trustees, key employees, and former insiders who have been compensated over a five-year look-back period. These disclosures go hand-in-hand with the new Schedule J that requires even more detailed disclosures concerning those individuals listed on the core form whose compensation exceeds certain amounts.

This new schedule requires organizations to provide a detailed breakdown of

reportable compensation and non-reportable compensation (such as the value of housing provided by the organization, education assistance, life insurance and disability benefits) and also includes questions about other miscellaneous benefits provided to insiders, such as expense accounts, first-class travel, payment of health club dues, or chauffeur services. If an organization reports providing any of these benefits, but does not have policies or procedures in place for handling them, it could raise a red flag for the IRS.

Beyond disclosing compensation amounts, the revised Form 990 requires disclosure of the method by which compensation for the organization's top management was established. The core form asks whether the organization followed an IRS-sanctioned process for establishing a rebuttable presumption of reasonable compensation of top management officials, officers and key employees. The process includes a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision.

OTHER TRANSACTIONS WITH INTERESTED PARTIES

The revised Form 990 includes many more questions on transactions between the organization and insiders, as well as relationships and arrangements among or between insiders themselves. Some questions are direct, while others are less explicit. The organization must disclose in yes or no format whether there are any family or business relationships among its officers, directors or key employees.

Additionally, the organization is required to report whether or not it complies with a written conflict of interest policy and whether conflicts are required to be disclosed annually by insiders. Although these questions do not explicitly relate to EBTs, they inquire about underlying governance practices that could demonstrate the organization's failure to take proper steps to prevent such transactions from occurring.

Most transactions involving insiders must be reported in the new Schedule L. Organizations that engaged in known EBTs, loans, grants, or business transactions with insiders and other interested persons are

required to complete this deceptively simple one-page schedule.

If known EBTs occurred or were discovered during the tax year, the organization must identify the disqualified persons and organization managers who knowingly participated in the EBT by name (not just by title), and include a description of the transaction. The organization must also indicate whether or not the transaction has been corrected, the amount of Intermediate Sanctions excise tax imposed, and the amount of tax reimbursed by the organization, if any.

Other business transactions (such as compensation, contracts of sale, lease, license, and performance of services) with current or former insiders, their family members, and other organizations controlled or managed by insiders must also be reported. All of these transactions raise potential excess benefit concerns, depending on the terms of the arrangement.

Note that disclosure of loans with insiders not only raises excess benefit concerns, it might also implicate state law compliance issues. For instance, some states, like New York, prohibit loans by a nonprofit to its directors and officers.

MATERIAL DIVERSIONS OF ASSETS

In addition to compensation and other transactions involving insiders, an excess benefit can occur when an insider receives unauthorized benefits, e.g., through theft or embezzlement. These "material diversions of assets" must now be reported on the Form 990. In particular, the 990 asks whether an organization became aware of a material diversion of its assets, including those that may have occurred during a previous tax year but were only discovered during the current tax year. The organization must disclose the nature and amounts of the diversion and corrective actions taken.

POTENTIAL CONSEQUENCES OF EBTs

Disqualified persons who receive excess benefits are subject to excise taxes known as Intermediate Sanctions. The excise taxes may be imposed in two tiers. A first-tier tax

of 25 percent of the excess benefit may be imposed for each EBT. If the initial 25 percent tax is imposed and the excess benefit is not corrected within a certain period of time, an additional second-tier excise tax equal to 200 percent of the excess benefit may be imposed.

The IRS can also impose a 10 percent excise tax, up to \$20,000, on any organization manager (e.g., officers and directors) who knowingly participated in an EBT without reasonable cause.

Beyond these financial penalties, the IRS also has the power to revoke an organization's tax-exempt status. However, revocation of tax-exempt status is a harsh penalty, and one that the IRS prefers to use only in cases of egregious or repeated violations. In fact, intermediate sanctions were developed precisely because the IRS wanted a more moderate penalty to impose.

The IRS released a Treasury Decision in 2008 setting forth a five-factor test for determining when an organization that has engaged in an EBT should have its exempt status revoked. The IRS will consider all relevant facts and circumstances, including:

- The size and scope of the organiza-

tion's exempt activities before and after the EBT;

- The size and scope of the EBT in relation to the size and scope of the organization's exempt activities;

- Whether the organization has been involved in multiple EBTs with one or more persons;

- Whether the organization has implemented safeguards that are reasonably calculated to prevent EBTs; and,

- Whether the EBT has been corrected or the organization has made good faith efforts to seek correction from the disqualified person(s) who benefited from the EBT.

The IRS has emphasized that the last two factors relating to implementation of safeguards and steps taken to correct EBTs (or lack thereof) are particularly important in its evaluation of whether to revoke an organization's tax-exempt status.

CORRECTIVE AND PREVENTATIVE MEASURES

An organization that is concerned that an EBT might have occurred or is seeking to pre-

vent one can take four key actions to avoid tax penalties and mitigate the risks of jeopardizing its exempt status. Those actions are:

- *Review organizational activities for potential EBTs:* Contracts, transactions, and even informal unwritten agreements with insiders should be reviewed to ensure that all financial arrangements are reasonable and in the best interest of the organization.

- *Take corrective action if necessary:* A correction generally means reversing the EBT to the extent possible. This includes taking any additional measures necessary to place the organization in a financial position no worse than it would have been if the disqualified person had dealt under the highest fiduciary standards. In deciding whether to revoke an organization's exempt status, the IRS will look more favorably upon an organization that took corrective action before the EBT is discovered by the IRS.

- *Establish written procedures to prevent future EBTs:* Certain policies and procedures can provide guidance to organizations and help ensure that it does not enter into EBTs, in particular, a comprehensive conflict of interest policy, joint venture policy, whistleblower policy, and executive

compensation review policy.

- *Monitor compliance with procedures:* The IRS is interested in knowing that organizations are not only adopting policies to assist them in tax-exempt compliance, but that they are regularly and consistently monitoring and enforcing compliance with those policies. Annual distribution of disclosure statements to all officers, directors, and key employees which require information on possible or actual conflicts of interest, family and business relationships and other pertinent disclosures, can assist the organization in establishing a regularly scheduled monitoring mechanism.

Moreover, the IRS considers the use of an annual disclosure statement as a reasonable effort by the organization to collect the information needed to respond to the Form 990 questions, and has stated that the organization can reasonably rely on those responses in making its disclosures. **NPT**

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