MASTER CLASS

Engaging with Related Parties

The Landscape of Excess Benefit Transactions

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Agenda

- **Introductions / Perspectives**
- **Grounding Principles: Beyond IRC Section 4958**
- **Intermediate Sanctions: Federal Tax Law Framework for 501(c)(3) Public Charities and 501(c)(4) Social Welfare Organizations**
- **Mitigating Exposure: Rebuttable Presumption Procedures & Safe Harbor for Reliance on Professional Advice**
- **Examples:**
  - **Executive Compensation**
  - **Transactions with Related For-Profit Entities**
- **Reporting on Form 990**
- **Questions?**

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Grounding Principles: Beyond Section 4958

- Private inurement
- Private benefit
- Conflicts of Interest
  - Policies
  - Processes
  - State law and principles
- State regulation
  - Nonprofit corporation and other state law
  - "Charitable trust" doctrine and similar laws/doctrines
  - Related state regulation by state Attorneys General or other state regulators
  - No rebuttable presumption for similar transactions under most state laws
- Governance-related documentation
- Disclosure, Optics
- Section 4960 implications

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Private Inurement

- A fundamental tenet of 501(c)(3) is the prohibition against **private inurement** -- the diversion of an organization's assets, which are supposed to be dedicated to charitable purposes, to an **insider** of the organization.

  > "***An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals***." Treas. Reg. Section 1.501(c)(3)-(1)(c)(2).

- Technically, $1 of private inurement –e.g., excessive compensation—would be grounds to disqualify an organization from tax-exempt status under IRC Section 501(c)(3). *See* American Campaign Academy v. Commissioner, 92 T.C. 1053, 1068 (1989).

- In some cases, the transactions are so egregious that they threaten the organization's exempt status. That is, the IRS may revoke the exemption, or deny an application for recognition of tax-exempt status, on this basis.

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IRC Section 4958: Intermediate Sanctions

To govern the less egregious cases, where outright revocation of exempt status is not warranted, Congress enacted section 4958 of the Internal Revenue Code, which imposes excise tax penalties -- called "intermediate sanctions" -- on both the insiders who benefit from an excess benefit transaction and any managers of the charity who approved the transaction knowing that it was impermissible.

- Section 4958 effectively precludes an organization that is exempt under **either Section 501(c)(3) or 501(c)(4)** from conferring "excess benefits" upon certain private individuals, defined as the organization's "disqualified persons."
- An "**excess benefit transaction**" is any transaction with a disqualified person where the value of the benefit conferred upon that person exceeds the value of the consideration received in exchange.
- Examples: excessive executive compensation, below-market interest rate loans from the charity to a DP (or above market interest rate loans from DPs to the charity). Also any transactions or arrangements involving payment for goods, services, real estate, or IP.
- We will focus on Section 501(c)(3) charities.

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"Disqualified Persons" Defined

Any person who was **in a position** to **exercise substantial influence** over the charity's affairs at any time during the **5-year period** ending on the date of the transaction.

- "Person" could be an entity.
- Because of this "look-back" rule, excessive payments (e.g., consulting fees) to a *former* board member or executive of a charity could be subject to penalties.
- Individual does not have to actually exercise substantial influence – just needs to be in a position to be able to.

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