

Excess Benefit Transactions

What is an excess benefit transaction?

An excess benefit transaction is a transaction in which an economic benefit is provided by an applicable tax-exempt organization, directly or indirectly, to or for the use of a *disqualified person*, and the value of the economic benefit provided by the organization exceeds the value of the consideration received by the organization.

A *disqualified person* is any person who was in a position to exercise substantial influence over the affairs of the tax-exempt organization. It is not necessary that the person actually exercise substantial influence, only that the person be in a position to do so. Family members of the disqualified person and entities controlled by the disqualified person are also disqualified persons.

How do I determine if an excess benefit has occurred?

To determine if an excess benefit transaction occurred, include all consideration and benefits exchanged between or among the disqualified person and the applicable tax-exempt organization and all entities it controls.

In an excess benefit transaction, the general rule for the valuation of property, including the right to use property, is fair market value. Fair market value is the price at which property, or the right to use property, would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell, or transfer property or the right to use property, and both having reasonable knowledge of all relevant facts.

An excess benefit can occur in an exchange of compensation and other compensatory benefits in return for the services of a disqualified person, or in an exchange of property between a disqualified person and the applicable tax-exempt organization.

The general rule is an excess benefit transaction occurred when the disqualified person received the economic benefit from the organization for federal income tax purposes.

Excise Taxes Imposed on Disqualified Persons

IRC 4958 imposes excise taxes on excess benefit transactions between disqualified persons and tax-exempt organizations described in either IRC 501(c)(3) or IRC 501(c)(4). IRC 4958 creates a two-tier excise tax structure on excess benefit transactions:

First-tier tax

The first-tier tax (sometimes referred to as the “initial tax”) is 25 percent of the excess benefit resulting from each excess benefit transaction between an organization and a disqualified person.

The 25 percent tax is payable by the disqualified person who received the excess benefit from the excess benefit transaction. If more than one disqualified person is liable for the 25 percent tax, all

are jointly and severally liable for the tax. Joint and several liability means that all or a portion of the 25 percent tax may be assessed against and collected from one or more of the disqualified persons who received an excess benefit from the excess benefit transaction. However, the total tax collected would not exceed 100 percent of the 25 percent tax. Under certain circumstances, the 25 percent tax may be abated.

Second-tier tax

The second-tier tax (sometimes referred to as the “additional tax”) is 200 percent of the excess benefit resulting from each excess benefit transaction between an organization and the disqualified person.

So, a disqualified person liable for the 25 percent tax may avoid the 200 percent tax by properly correcting all the excess benefit (and interest) within the taxable period. But if a disqualified person does not correct all the excess benefit (and interest), the 200 percent would be imposed only on the uncorrected portion of the excess benefit.

The 200 percent tax is payable by the disqualified person who received the excess benefit from the excess benefit transaction. If more than one disqualified person is liable for the 200 percent tax, all the disqualified persons are jointly and severally liable for the tax. However, the total tax collected would not exceed 100 percent of the 200 percent tax. Under certain circumstances, the 200 percent tax may be abated.

Correcting the Excess Benefit

A disqualified person corrects an excess benefit transaction by undoing the excess benefit to the extent possible, and by 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. The organization is not required to rescind the underlying agreement; however, the parties may need to modify an ongoing contract with respect to future payments.

A disqualified person corrects an excess benefit transaction by making a payment in cash or cash equivalents equal to the correction amount to the applicable tax-exempt organization. The correction amount equals the excess benefit plus the interest on the excess benefit. The interest rate may be no lower than the applicable federal rate. There is an anti-abuse rule to prevent the disqualified person from effectively transferring property other than cash or cash equivalents.

With the agreement of the applicable tax-exempt organization, a disqualified person may make a payment by returning the specific property previously transferred in the excess benefit transaction. The return of property is considered a payment of cash (or cash equivalent) equal to the lesser of:

- The fair market value of the property on the date the property is returned to the organization, or
- The fair market value of the property on the date the excess benefit transaction occurred.

If the payment resulting from the return of property is less than the correction amount, the disqualified person must make an additional cash payment to the organization equal to the difference.

If the payment resulting from the return of the property exceeds the correction amount, the organization may make a cash payment to the disqualified person equal to the difference.

Excise Taxes Imposed on Organization Managers

IRC 4958 imposes a tax of 10 percent of the excess benefit on the participation of an organization manager in an excess benefit transaction between an organization and a disqualified person. An organization manager is any officer, director, or trustee of an applicable tax-exempt organization, or any individual having powers or responsibilities similar to officers, directors, or trustees of the organization, regardless of title. An officer includes the following persons, regardless of their titles: top management official (the person who has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization; for example, the organization's president, CEO, or executive director) and top financial official (the person who has ultimate responsibility for managing the organization's finances).

The 10 percent tax applies if:

- The 25 percent tax has been imposed on the disqualified person;
- The organization manager knowingly participated in the excess benefit transaction, and
- The organization manager's participation was willful and not due to reasonable cause.

The 10 percent is payable by the organization manager who participated in the excess benefit transaction. The maximum aggregate amount of 10 percent tax that may be imposed on an organization manager for each excess benefit transaction is \$20,000. So, if more than one organization manager knowingly participated in an excess benefit transaction, \$20,000 is the maximum amount of 10 percent tax that may be collected from all the organization managers collectively, for their participation in that particular excess benefit transaction. If more than one organization manager is liable for the 10 percent tax, all the organization managers are jointly and severally liable for the tax. However, the total tax collected cannot be more than 100 percent of the 10 percent tax. If the 25 percent tax imposed on the disqualified person were abated, the 10 percent tax would be abated automatically.

An organization manager who is also a disqualified person can be liable for the 25 percent tax as well as the 10 percent tax if he or she benefited from the excess benefit transaction.

What is meant by knowing participation?

Participation in an excess benefit transaction includes affirmative action and silence or inaction where the organization manager is under a duty to speak or act. However, an organization manager is not considered to have participated in an excess benefit transaction where the organization manager has opposed the transaction in a manner consistent with fulfillment of the organization manager's responsibilities to the organization.

For more information, see www.irs.gov.