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IRS ISSUES

Excess Benefits: "Disqualified Person" Broadened

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A recent ruling from the United States Tax Court reminds us that, notwithstanding crises and emergencies or some loosening of policies and procedures by the government or funders, the key rules and restrictions of Internal Revenue Code section 501(c)(3) continue to apply.

In *Vincent J. Fumo v. Commissioner*, T.C. Memo. 2021-61 (May 17, 2021), Judge Albert Lauber upheld an expansive definition of "disqualified person" for purposes of the excise tax imposed under Internal Revenue Code section 4958 on "excess-benefit transactions." Sometimes described euphemistically as "intermediate sanctions," it's only good news when compared with the only available – draconian – remedy before 1996: namely, revocation of tax-exempt status.

What's Not Allowed

Simply put, certain reasonable and arms-length transactions (including, for instance, some types and amount of compensation) between an organization and an "insider" are permitted. But certain other arrangements – those generally described as "self-dealing' or "inurement of net earnings" – are not allowed. See *Excess Benefit Transactions* (January 1, 2020) Magdalena M. Czerniawski, CPA, MBA, and Robert Lyons, CPA, MST, NYS Society of CPAs. See also "Intermediate sanctions – excess benefit transactions" and "Intermediate sanctions – compensation" on the IRS website.

Section 4958 includes a two-level enforcement scheme. Initially, there is an excise tax of 25% of the "excess benefit." This amount is imposed on the person who committed the infringement but in some cases also on the 501(c)(3) management that "allowed it to happen." If there is no "correction" within the specified period, the excise tax can jump to 200%, with a cap of no more than $20,000 per occurrence. The "excess benefit" incident(s) are reportable on Form 4720, "Return of Certain Excise Taxes under Chapters 41 and 42 of the Internal Revenue Code."

"Congress enacted section 4958 not to collect revenue but to 'deter insiders of an organization from using their positions of influence to receive unreasonable compensation.'" Also, since earlier all-or-nothing remedy of "revocation 'falls on the organization …. rather than" on the individuals who wrongfully benefited, a middle-ground alternative was needed. "Intermediate sanctions are intended to deter malfeasance and incentivize insiders to restore the charity to the status quo ante"; the 200% tax goes away if the "insider corrects the excess benefit transaction." *Gloria Ononuju v. Commissioner,* T.C. Memo 2021-94 (July 26, 2021) [J. Lauber].

Politician Abuses Charity

"The facts of this case are extreme" but – alas – not unheard of or entirely unfamiliar to us in modern America.

Former Pennsylvania state senator Vincent Fumo was convicted in 2009 on federal corruption crimes and ordered to prison. But ten years earlier, he had "directed" members of his staff to first create a 501(c)(3) organization and then to run it. While Fumo "had no formal role," he used his government position and power to "direct funds to the organization." He also "received extensive [financial] benefits from the charity. See *US Tax Court Finds "Disqualified Person" Definition For Nonprofit Excess Benefit Rules Is Expansive* (May 18, 2021) Robert Romashko, Esq. and Rachel Scott, Esq., Husch Blackwell LLP.

Once the criminal trial ended, the Internal Revenue Service chimed in with civil consequences: The federal tax agency imposed the 25% excess benefits sanction of Internal Revenue Code section 4958(a)(1) on the disgraced politician.

Procedurally, the case came before the U.S. Tax Court on a two-issue motion for summary judgment by the government. First, the IRS asked the Court to rule that Fumo was a disqualified person within the meaning of section 4958. Judge Lauber obliged in what's called a "memorandum opinion." See T.C. Memo 2021-61. "Generally, a Memorandum Opinion is issued in a regular case that does not involve a novel legal issue" but instead "addresses cases where the law is settled or factually driven."

On this first issue, Judge Lauber weighed several of the factors set out in section 43.4958-3 of the Foundation Excise Tax Regulations, finding that – taken as a whole – "Fumo was a disqualified person in spite of his having no formal role in the organization." Also: "Fumo was not a technical 'incorporator' of the charity, but he directed its creation. Fumo did not directly contribute funds to the charity, but he raised funds on its behalf. Although he had no formal decision-making authority, in practice he had exerted significant authority over the charity's major decisions…."

The second summary-judgment issue – namely, whether "Fumo had in fact received some excess benefits from the charity" – was a matter for decision during trial instead of via pre-trial motion.

Effect of Ruling

The significance of this case, according to attorneys Romashko and Scott is that "[m]anagers of tax-exempt organizations should be aware of the opinion because it provides guidance as to when a person without formal affiliation with an organization will be held to be disqualified persons to whom the excess benefit transaction rules apply."

See also *Tax Court concludes former State senator convicted of fraud also deemed a 'disqualified person' for intermediate sanctions purposes* (May 21, 2021) Ernst & Young LLP. "This decision by the Tax Court provides a fairly straightforward interpretation of the factors necessary to establish that an individual is a disqualified person as enumerated in IRC Section 4958. Specifically, the court rejected the petitioner's 'hypertechnical arguments' that one must be the literal incorporator of an organization or hold a formal title within the organization to be characterized as a disqualified person."

Conclusion

The Ernst & Young Tax Alert advises the nonprofit community including its professional advisors that "[b]y focusing on the plain language of the regulations and ruling on their meaning, the court has effectively eliminated loopholes that persons receiving excess benefits may have previously tried to exploit."

— Linda J. Rosenthal, J.D., FPLG Information & Research Director