

# “Automatic” Excess Benefit Transactions Under IRC 4958

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## Overview

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**Purpose** This article will discuss when economic benefits received by a disqualified person from an applicable tax-exempt organization which are compensation for income tax purposes and wages for employment tax purposes should be treated as “automatic” excess benefit transactions under IRC 4958.

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## Overview, Continued

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### Previous CPE Articles

Previous CPE articles involving IRC 4958 are:

- “Section 4958 Update,” FY 2000 EO CPE 21
  - “An Introduction to I.R.C. 4958 (Intermediate Sanctions),” FY 2002 EO CPE 259
  - “Intermediate Sanctions (IRC 4958) Update,” FY 2003 EO CPE E-1
- 

### IRC 4958 Documents

IRS documents in which IRC 4958 is discussed are listed below. Under IRC 6110(k)(3), none of these documents may be used or cited as precedent.

- TAM 200244028 (6/21/02)
  - TAM 200243057 (7/2/02)
  - PLR 200247055 (11/22/02)
  - Information Letter 2002-14 (12/23/03)
  - PLR 200332018 (5/13/03)
  - PLR 200335037 (6/2/03)
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## “Compensation” and “Wages”

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### **Different Definitions**

The definition of “compensation” under IRC 61(a)(1) for income tax purposes, “wages” under IRC 3121(a) for employment tax purposes, and “compensation” under IRC 4958 for excess benefit transaction purposes, are not necessarily the same, since each provision has a different statutory purpose.

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### **Compensation Under IRC 61(a)(1)**

IRC 61(a)(1) provides that “gross income” includes “compensation for services, including fees, commissions, fringe benefits and similar items.” Reg. 1.61-2(a)(1).

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### **Payment in Property**

If services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation, except in the case of property that is subject to a substantial risk of forfeiture under IRC 83. Reg. 1.61-2(d)(1).

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### **Definition of Wages**

“Wages” is defined as “all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash.” There are numerous exceptions to the items that are included as “wages.” IRC 3121(a); IRC 3401(a).

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### **Employment Taxes**

Employers are required to withhold and pay certain employment taxes on the wages they pay to their employees, and are required to withhold income taxes from these wages. IRC 3101; IRC 3102; IRC 3111; IRC 3402.

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### **Filing Requirements**

Employers are required to file Form 941 (Employer’s Quarterly Federal Tax Return) and to periodically deposit the employment taxes and income taxes at an authorized financial institution or pay the employment taxes to the Service. Reg. 31.6302-1; Reg. 31.6302-2.

If an employer fails to deposit or pay the employment taxes required, the employer is liable for the entire amount of employment taxes, whether or not the employer has withheld any employment taxes from the wages the employer paid to the employee. Reg. 31.3102-1(a).

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## Compensation – Under IRC 4958

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### Intent

Although an economic benefit may be treated as compensation for income tax purposes and as wages for employment tax purposes, the economic benefit would be treated as compensation under IRC 4958 only if the exempt organization providing the benefit clearly indicated its intent to treat the benefit as compensation for services when the benefit was paid.

- If the benefit is treated as compensation under IRC 4958, Agents should consider the benefit along with any other compensation the disqualified person may have received to determine whether the aggregate compensation was reasonable.

See Reg. 53.4958-4(c)(1).

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### Written Contemporaneous Substantiation

An exempt organization (or entity controlled by the organization) is treated as clearly indicating its intent to treat an economic benefit as compensation for services only if the exempt organization provided written substantiation that is contemporaneous with the transfer of the particular benefit. Reg. 53.4958-4(c)(1).

If the written contemporaneous substantiation requirements are not satisfied, unless the exempt organization can establish that it provided the economic benefit in exchange for consideration other than the performance of services (for example, a bona fide loan), Agents should treat the economic benefit as an “automatic” excess benefit transaction without regard to whether:

- The economic benefit is reasonable,
- Any other compensation the disqualified person may have received is reasonable, or
- The aggregate of the economic benefit and any other compensation the disqualified person may have received is reasonable.

Reg. 53.4958-4(c)(1).

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## Written Contemporaneous Substantiation

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### **Timely Reporting of Benefits**

One method of providing written contemporaneous substantiation is by the timely reporting of economic benefits, either by the exempt organization or by the disqualified person.

The exempt organization reports the economic benefit as compensation on an original Federal tax information return (Form 990, Form W-2 or Form 1099), or on an amended Federal tax information return filed before the start of an IRS examination of either the exempt organization or the disqualified person for the year when the transaction occurred.

The disqualified person reports the economic benefit as income on an original Federal tax return (Form 1040), or on an amended Federal tax return filed before the earlier of:

- The start of an IRS examination of either the exempt organization or the disqualified person for the year when the transaction occurred, or
- The first written documentation by the IRS of a potential excess benefit transaction involving either the exempt organization or the disqualified person.

Reg. 53.4958-4(c)(3)(i)(A).

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## Written Contemporaneous Substantiation, Continued

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### “Reasonable Cause”

If an exempt organization failed to report an economic benefit as compensation, but this failure was due to “reasonable cause,” the exempt organization is treated as having clearly indicated its intent to provide the economic benefit as compensation for services. Reg. 53.4958-4(c)(3)(i)(B).

“Reasonable cause” for this purpose is determined under Reg. 301.6724-1.

To show that an applicable tax-exempt organization’s failure to report an economic benefit that should have reported on an information return was due to “reasonable cause”, an organization must establish that:

- There were significant mitigating factors as to its failure to report. Reg. 301.6724-1(b), or
- The failure arose from events beyond the organization’s control. Reg. 301.6724-1(c), and
- The exempt organization acted in a responsible manner both before and after the failure occurred. Reg. 301.6724-1(d).

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## Written Contemporaneous Substantiation, Continued

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### Different “Reasonable Cause” Standard

The reasonable cause standard for the failure of an exempt organization to report an economic benefit as compensation is different from the reasonable cause standard used in other IRC 4958 situations.

For example:

- In determining whether an organization manager’s participation in an excess benefit transaction was due to “reasonable cause” under Reg. 53.4958-1(d)(1), “reasonable cause” is the exercise of responsibility on behalf of the exempt organization with “ordinary business care and prudence.” Reg. 53.4958-1(d)(6).
- In determining whether the 25% excise tax under IRC 4958(a)(1) should be assessed against a disqualified person, or if assessed, whether it should be abated under IRC 4962, “reasonable cause” means exercising “ordinary business care and prudence.” Reg. 53.4958-1(d)(6); Reg. 53.4941(a)-1(b)(5); Reg. 301.6651-1(c); United States v. Boyle, 469 U.S. 241, 246 (1985).

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## Written Contemporaneous Substantiation, Continued

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### **Other Written Contemporaneous Evidence**

Other written contemporaneous evidence may be used to demonstrate that the organization, through the appropriate decision-making body or an officer authorized to approve compensation, approved a transfer as compensation in accordance with established procedures, which include, but are not limited to:

- An approved written employment contract executed on or before the date of transfer.
- Appropriate documentation indicating that an authorized body approved the transfer as compensation for services on or before the date of the transfer.
- Written evidence, that existed on or before the due date of the appropriate Federal tax return (Form 990, Form W-2, Form 1099 or Form 1040), including extensions but not amendments of the return, of a reasonable belief by the exempt organization that under the Internal Revenue Code, the benefit was excludable from the disqualified person's gross income.

See Reg. 53.4958-4(c)(3)(ii).

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### **Requirements Satisfied**

If the requirements for written contemporaneous substantiation are satisfied, the economic benefit is treated as compensation and is added to the disqualified person's other compensation to determine whether, in the aggregate, all or any portion of the disqualified person's compensation is unreasonable. Reg. 53.4958-4(c)(1).

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## Accountable Plans

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**Certain  
Benefits  
Disregarded**

In determining whether an excess benefit transaction occurred, all consideration and benefits exchanged between a disqualified person and the exempt organization and all entities the exempt organization controls are taken into account. Reg. 53.4958-4(a)(1).

However, certain economic benefits are disregarded for purposes of IRC 4958. Reg. 53.4958-4(a)(4).

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**Expense  
Reimburse-  
ments Under an  
“Accountable  
Plan”**

Reimbursements of expenses incurred by a disqualified person, paid by an exempt organization to the disqualified person, are disregarded under IRC 4958 if the expense reimbursements are made in compliance with an arrangement that qualifies as an “accountable plan” under Reg. 1.62-2(c)(2). Reg. 53.4958-4(a)(4)(ii).

Payments under an “accountable plan” are excluded from the employee’s gross income, are not reported as wages or other compensation on the employee’s Form W-2, and are exempt from withholding and payment of employment taxes. Reg. 1.62-2(c)(4).

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## Accountable Plans, Continued

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### Expense Reimbursements Under a “Non-Accountable Plan”

Reimbursements of expenses incurred by a disqualified person, paid by an exempt organization to the disqualified person under an arrangement that is a “nonaccountable plan” under Reg. 1.62-2(c)(3), may be subject to IRC 4958. If the exempt organization clearly indicates its intent to treat the reimbursements as compensation for services by satisfying the written contemporaneous substantiation requirements, Agents should treat the reimbursements as compensation and add them to the disqualified person’s other compensation to determine whether, in the aggregate, all or any portion of the disqualified person’s compensation is unreasonable..

However, if the organization does not satisfy the written contemporaneous substantiation requirements in Reg. 53.4958-4(c)(1), Agents should treat the reimbursements paid under a “nonaccountable plan” as “automatic” excess benefit transactions without regard to whether:

- The reimbursements are reasonable,
- Any other compensation the disqualified persons may have received is reasonable, or
- The aggregate of the reimbursements and any other compensation the disqualified person may have received is reasonable.

Reg. 53.4958-4(c)(1).

Payments under a “nonaccountable plan” are included in the employee’s gross income, are reported on the employee’s Form W-2 as wages or other compensation, and are subject to withholding and payment of employment taxes. Reg. 1.62-2(c)(5).

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## Form 4720 Required

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### **Form 4720**

The IRS has the authority to issue regulations requiring that any person who is liable for any tax file a return. IRC 6011(a).

A disqualified person (or an organization manager) who is liable for tax imposed by IRC 4958 is required to file Form 4720 *Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code*. IRC 6011(a).

Form 4720 must be filed annually reporting the excess benefit transactions that occurred which give rise to the tax liability under IRC 4958. Reg. 53.6011-1(b).

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### **Penalty for Failure to File**

If a disqualified person (or an organization manager) required to file Form 4720 did not file Form 4720 on or before the required due date, including extensions of time, a penalty of 5% of the amount of the correct tax under IRC 4958 would apply if the failure to file was not more than one month.

For each additional month that the disqualified person (or the organization manager) did not file Form 4720, a penalty of 5% per month applies, but not exceeding 25% in total.

If the disqualified person (or the organization manager) establishes that the failure to file was due to reasonable cause and not due to willful neglect, the penalty would not apply.

See IRC 6651(a)(1); Reg. 301.6651-1(a)(1).

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## Form 4720 Required, Continued

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### **Penalty for Failure to Pay**

If a disqualified person (or an organization manager) required to file Form 4720 did not pay the excise taxes that should have been reported on Form 4720 on or before the required due date, including extensions of time, a penalty of 1/2% of the amount of the correct tax under IRC 4958 would apply if the failure to pay was not more than one month.

For each additional month that the disqualified person (or the organization manager) did not pay the required excise taxes, a penalty of 1/2% per month applies, but not exceeding 25% in total.

If the disqualified person (or the organization manager) establishes that the failure to pay was due to reasonable cause and not due to willful neglect, the penalty would not apply.

See IRC 6651(a)(3); Reg. 301.6651-1(a)(3).

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### **Penalties Not Cumulative**

The penalty for the failure to file and the penalty for the failure to pay cannot exceed 25% in the aggregate. IRC 6651(c)(1).

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### **Fraud**

If the failure to file Form 4720 is fraudulent, the penalty for failure to file Form 4720 is increased from 5% to 15%, and the maximum penalty is increased from 25% to 75%. IRC 6651(f).

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### **Substitute Form 4720**

If a disqualified person (or an organization manager) required to file Form 4720 did not file Form 4720, the IRS may have to prepare a substitute Form 4720. IRC 6020(b); Reg. 301.6020-1(b).

A substitute Form 4720 prepared by the IRS is a valid Form 4720 for all legal purposes. IRC 6020(b)(2); Reg. 301.6020-1(b)(2).

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### **Substitute Form 4720 Penalties**

If a disqualified person (or an organization manager) required to file Form 4720 did not file Form 4720, and the IRS prepares a substitute Form 4720, the penalties for failure to file would not apply to the substitute Form 4720 but the penalties for failure to pay would apply. IRC 6651(g); Reg. 301.6651-1(g).

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## Tips for Agents

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### **Introduction**

In examining economic benefits involving an exempt organization and its disqualified persons, Agents should consider:

- Agreements
  - Loans
  - Expense reimbursements or payments
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### **Agreements**

Agents should review all agreements providing any type of economic benefits to any disqualified persons, to any member of their family and to any organizations in which the disqualified persons or any family members have an ownership interest.

Agreements that should be reviewed include:

- Employment agreements
  - Deferred compensation agreements
  - Bonus agreements
  - Retirement agreements
  - Severance agreements
  - Agreements for the purchase and sale of any goods or services
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### **Loans**

Agents should review all loan arrangements between the exempt organization and all disqualified persons, and review all loan documents.

Agents should determine whether payments were made in compliance with the loan documents.

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### **Expense Reimbursements or Payments**

Agents should review all expense reimbursements made by the exempt organization to all disqualified persons.

Agents should review all expenses paid by the exempt organization to or on behalf of all disqualified persons.

Agents should determine whether the expense reimbursements or payments were made in compliance with an “accountable plan” under Reg. 1.62-2(c)(2).

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## Example 1 – No Excess Benefit Transaction

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### Facts

EO is tax-exempt under IRC 501(c)(3). From 1998 through 2002, EO paid its President a salary of \$50,000 per year. In 2002, EO paid \$35,000 for the President and the President's spouse to take a vacation cruise around the world. EO intended for this benefit to be additional compensation to the President, at the rate of \$7,000 per year, for services the President performed for EO from 1998 through 2002.

During 2002, as to the \$35,000 payment, EO withheld additional federal income taxes and employment taxes from the President's salary, reported the \$35,000 payment as wages on its Form 941 for the appropriate calendar quarter and paid the appropriate income taxes and employment taxes as to the \$35,000.

On EO's Form 990 for 2002, EO reported \$85,000 as compensation to the President. In response to Question 89b on Form 990, EO answered "No." EO reported \$85,000 as compensation on the President's Form W-2 for 2002. The President reported \$85,000 as compensation on Form 1040 for 2002.

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## Example 1 – No Excess Benefit Transaction, Continued

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### IRS Examination

For 1998 through 2002, the IRS examined EO's Form 990. As a result, the IRS determined that:

- If the total compensation EO paid the President from 1998 through 2002 is treated as \$57,000 per year, this amount was reasonable in relation to the value of the services EO received from the President during this period.
- If the total compensation EO paid the President in 2002 is treated as \$85,000, this amount was reasonable in relation to the value of the services EO received from the President in 2002.
- None of the \$50,000 annual salary EO paid the President from 1998 through 2002, and none of the \$35,000 it paid in 2002 on behalf of the President, constituted inurement under Reg. 1.501(c)(3)-1(c)(2) or impermissible private benefit under Reg. 1.501(c)(3)-1(d)(1)(ii).
- The President was a disqualified person as to EO under IRC 4958(f)(1) and Reg. 53.4958-3.
- Reporting the \$35,000 of benefits satisfied the written contemporaneous substantiation requirements under Reg. 53.4958-4(c)(3).

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### Conclusion

Whether the President is treated as having received compensation of \$57,000 per year from 1998 through 2002 or as having received \$85,000 of compensation in 2002, since neither amount was unreasonable, none of the \$35,000 EO paid for the vacation cruise constituted an excess benefit transaction under IRC 4958(c)(1) and Reg. 53.4958-4.

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## Example 2 – Excess Benefit Transaction

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### Facts

EO is tax-exempt under IRC 501(c)(3). From 1998 through 2002, EO paid its President a salary of \$50,000 per year. In 2002, EO paid \$35,000 for the President and the President's spouse to take a vacation cruise around the world. EO intended for this benefit to be additional compensation to the President, at the rate of \$7,000 per year, for services the President performed for EO from 1998 through 2002.

During 2002, as to the \$35,000 payment, EO did not withhold additional federal income taxes or employment taxes from the President's salary, did not report the \$35,000 payment as wages on its Form 941 for the appropriate calendar quarter and did not pay the appropriate income taxes and employment taxes as to the \$35,000.

On EO's Form 990 for 2002, EO reported only \$50,000 as compensation to the President. In response to Question 89b on Form 990, EO answered "No." EO reported only \$50,000 as compensation on the President's Form W-2 for 2002. The President reported only \$50,000 as compensation on Form 1040 for 2002.

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## Example 2 – Excess Benefit Transaction, Continued

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### IRS Examination

For 1998 through 2002, the IRS examined EO's Form 990. As a result, the IRS determined that:

- If the total compensation EO paid the President from 1998 through 2002 is treated as \$57,000 per year, this amount was reasonable in relation to the value of the services EO received from the President during this period.
- If the total compensation EO paid the President in 2002 is treated as \$85,000, this amount was reasonable in relation to the value of the services EO received from the President from 1998 through 2002.
- None of the \$50,000 annual salary EO paid the President from 1998 through 2002, and none of the \$35,000 it paid in 2002 on behalf of the President, constituted inurement under Reg. 1.501(c)(3)-1(c)(2) or impermissible private benefit under Reg. 1.501(c)(3)-1(d)(1)(ii).
- The President was a disqualified person as to EO under IRC 4958(f)(1) and Reg. 53.4958-3.
- The \$35,000 constituted "wages" under IRC 3121(a) and IRC 3401(a). Consequently, EO is liable for the appropriate amount of employment taxes and income taxes on the \$35,000. IRC 3101; IRC 3102; IRC 3111; IRC 3402.
- As to the \$35,000, EO did not satisfy the written contemporaneous substantiation requirements under Reg. 53.4958-4(c)(3)(i)(A) because:
  - EO did not report the \$35,000 as compensation on an original Form 990, Form W-2 or Form 1099 for 2002, or on an amended Form 990, Form W-2 or Form 1099 that was filed before the start of the IRS examination for 2002.
  - The President did not report the \$35,000 as compensation on an original Form 1040 for 2002 or on an amended Form 1040 for 2002 that was filed before the earlier of:
    - The start of an IRS examination of either the exempt organization or the disqualified person for 2002, or

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## Example 2 – Excess Benefit Transaction, Continued

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**IRS  
Examination,**  
(continued)

- The first written documentation by the IRS of a potential excess benefit transaction involving either the exempt organization or the disqualified person.
- EO did not establish that its failure to report the \$35,000 as compensation on a timely filed Form 990, Form W-2 or Form 1099 was due to “reasonable cause” under Reg. 301.6724-1. Reg. 53.4958-4 (c)(3)(i)(B).
- EO did not establish other contemporaneous evidence demonstrating that through EO’s appropriate decision-making body or officer authorized to approved compensation, EO approved the payment of \$35,000 in accordance with established procedures. Reg. 53.4958-4 (c)(3)(ii).
- None of the \$50,000 salary the President received from EO each year from 1998 through 2002 constituted an excess benefit transaction in 1998 through 2002 under IRC 4958(c)(1) and Reg. 53.4958-4.
- All of the \$35,000 payment EO paid in 2002 on behalf of the President was an “automatic” excess benefit transaction in 2002, despite the fact that:
  - The total compensation EO paid the President from 1998 through 2002, if treated as \$57,000 per year, was reasonable in relation to the value of the services EO received each year, or
  - The total compensation EO paid the President in 2002, if treated as \$85,000, was reasonable in relation to the value of the services EO received in 2002. IRC 4958(c)(1); Reg. 53.4958-4.
- The President is liable for the 25% excise tax under IRC 4958(a)(1) and the 200% excise tax under IRC 4958(b).
- If the President satisfied the requirements under IRC 4961 and IRC 4962, which includes correction of the excess benefit transaction, abatement of some or all of these taxes may occur.

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## Example 2 – Excess Benefit Transaction, Continued

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### IRS Examination, (continued)

- The President is not liable for the 100% penalty under IRC 6684. Although the President could not establish this excess benefit transaction was due to “reasonable cause” under Reg. 301.6684-1(b), under these facts, the IRS could not prove that it was “willful and flagrant” under Reg. 301.6684-1(c).
  - Since the President did not file Form 4720 reporting the \$35,000 as an excess benefit transaction, the IRS prepared a substitute Form 4720. IRC 6020(b); Reg. 301.6020-1(b)(2). Therefore, the President is liable for the penalty for failure to pay the applicable excise taxes under IRC 4958 on the \$35,000. IRC 6651(a)(3); Reg. 301.6651-1(a)(3).
  - All of the \$35,000 is includible in the President’s gross income in 2002 under IRC 61(a) and the President is liable for the appropriate income taxes on this amount.
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### Conclusions

Since the written contemporaneous substantiation requirements were not satisfied, the \$35,000 is not treated as compensation for purposes of IRC 4958. Therefore, \$35,000 is treated as an “automatic” excess benefit transaction without regard to whether:

- The \$35,000 benefit is reasonable,
- The \$50,000 annual salary is reasonable, or
- The aggregate economic benefits, whether treated as \$57,000 per year from 1998 through 2002 or as \$85,000 for 2002, are reasonable.

Reg. 53.4958-4(c)(1).

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## Example 3 – Correction

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**Facts** The facts are the same as in Example 2. In addition, in 2004, the President repays EO \$35,000 plus the appropriate amount of interest, as determined under Reg. 53.4958-7(c).

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**“Abatement”** If the disqualified person corrected the excess benefit transaction during the correction period, the 200% excise tax under IRC 4958(b) would be automatically abated. IRC 4961(a); Reg. 53.4961-1.

If the disqualified person corrected the excess benefit transaction during the correction period, the 25% excise tax under IRC 4958(a)(1) would be abated only if the disqualified person can establish that the excess benefit transaction was due to “reasonable cause” and was not due to “willful neglect.” IRC 4962.

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**“Reasonable Cause”** For this purpose, “reasonable cause” means exercising “ordinary business care and prudence.” Reg. 53.4958-1(d)(6); Reg. 53.4941(a)-1(b)(5); Reg. 301.6651-1(c); United States v. Boyle, 469 U.S. 241, 246 (1985).

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## Example 3 – Correction, Continued

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**“Willful Neglect”**

Not “willful neglect” means that the receipt of the excess benefit was not due to the disqualified person’s conscious, intentional or voluntary failure to comply with IRC 4958, and that the noncompliance was not due to conscious indifference. Reg. 53.4958-1(d)(5); Reg. 53.4941(a)-1(b)(4).

An act is “willful” if it is “voluntary, conscious, and intentional.” Reg. 53.4958-1(d)(5); Reg. 53.4941(a)-1(b)(4).

“Negligence” includes any failure to make a reasonable attempt to comply with the law. IRC 6662(c).

“Willful neglect” implies failure to exercise the care a reasonable person would observe under the circumstances to see that the standards were observed, despite knowledge of the standards or rules in question.

In United States v. Boyle, 469 U.S. 241 (1985), the Supreme Court stated that “willful neglect” means “a conscious, intentional failure or reckless indifference.” 469 U.S. at 245.

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## Example 3 – Correction, Continued

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### Conclusions

If the President can establish that in 2002, when EO paid \$35,000 on the President's behalf, this excess benefit transaction was due to "reasonable cause" and was not due to "willful neglect," the IRS would abate the 25% excise tax. IRC 4962(a).

However, if the President cannot establish both of these requirements, the President would be liable for the 25% excise tax under IRC 4958(a)(1), even though the President:

- Corrected the excess benefit transaction by paying \$35,000 plus interest to EO, and
- Paid federal income tax on the \$35,000 as additional compensation.

If the President can establish that the President's failure to pay the excise taxes that were required to be reported on Form 4720 for 2002, which the President did not file, was due to "reasonable cause" and was not due to "willful neglect," the IRS would abate the penalties for failure to pay. IRC 6651(a)(3); Reg. 301.6651-1(a)(3).

The President may deduct on Form 1040 for 2004, as a miscellaneous itemized deduction, the \$35,000 that the President paid to EO in 2002. IRC 67.

If IRC 1341 applies to the repaid \$35,000, this deduction would not be subject to the two-percent floor. IRC 67(b)(9).

In any event, the repaid \$35,000 would be subject to the overall limitation on itemized deductions. IRC 68.

The amount of interest the President paid in 2004 would not be deductible for federal income tax purposes.

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## Example 4 – Accountable Plan

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### Facts

EO is tax-exempt under IRC 501(c)(3). In 2002, EO paid its President a salary of \$50,000 per year. EO had adopted an expense reimbursement program that qualifies as an “accountable plan” under Reg. 1.62-2(c)(2).

In 2002, EO’s President traveled in connection with EO business and incurred travel expenses of \$2,500. In 2002, EO reimbursed the President \$2,500 for these travel expenses.

During 2002, EO did not withhold and pay employment taxes on the \$2,500 of expense reimbursements EO paid the President. In addition, EO did not report this \$2,500 as wages on its Form 941 for the appropriate calendar quarter in 2002 and did not include this amount as wages on the President’s Form W-2.

On EO’s Form 990 for 2002, EO reported \$50,000 as compensation to the President. In response to Question 89b on Form 990, EO answered “No.” EO reported \$50,000 as compensation on the President’s Form W-2 for 2002. The President reported \$50,000 as compensation on Form 1040 for 2002.

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## Example 4 – Accountable Plan, Continued

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### IRS Examination

The IRS examined EO's Form 990 for 2002. As a result of this examination, the IRS determined that:

- The travel expenses EO reimbursed the President for the President's travel were made under an "accountable plan" under Reg. 1.62-2(c)(2).
  - None of the \$50,000 salary EO paid the President for 2002 constituted inurement under Reg. 1.501(c)(3)-1(c)(2) or impermissible private benefit under Reg. 1.501(c)(3)-1(d)(1)(ii).
  - The President was a disqualified person as to EO under IRC 4958(f)(1) and Reg. 53.4958-3.
  - The \$2,500 did not constitute "wages" under IRC 3121(a) and IRC 3401(a). Consequently, EO is not liable for the appropriate amount of employment taxes or income taxes on the \$2,500. IRC 3101; IRC 3102; IRC 3111; IRC 3402.
  - Since EO paid the President \$2,500 under an "accountable plan," the \$2,500 is disregarded for purposes of IRC 4958. Reg. 53.4958-4(a)(4)(ii).
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## Example 5 – Noncountable Plan

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### Facts

EO is tax-exempt under IRC 501(c)(3). In 2002, EO paid its President a salary of \$50,000 per year. EO had adopted an expense reimbursement program that qualifies as an “accountable plan” under Reg. 1.62-2(c)(2).

In 2002, EO’s President traveled on a personal matter and incurred travel expenses of \$2,500. In 2002, EO reimbursed the President \$2,500 for these travel expenses.

During 2002, EO did not withhold and pay employment taxes or additional federal income taxes as to the \$2,500 of expense reimbursements EO paid the President. In addition, EO did not report this \$2,500 as wages on its Form 941 for the appropriate calendar quarter in 2002 and did not include this amount as wages on the President’s Form W-2 for 2002.

On EO’s Form 990 for 2002, EO reported \$50,000 as compensation to the President. In response to Question 89b on Form 990, EO answered “No.” EO reported only \$50,000 as compensation on the President’s Form W-2 for 2002. The President reported \$50,000 as compensation on Form 1040 for 2002.

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## Example 5 – Noncountable Plan, Continued

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### IRS Examination

The IRS examined EO's Form 990 for 2002. As a result of these examinations, the IRS determined that:

- The \$2,500 which EO reimbursed the President for the President's travel was not paid under an "accountable plan" under Reg. 1.62-2(c)(2).
- The total compensation EO paid the President for 2002, \$52,500, was reasonable in relation to the value of the services EO received from the President during 2002.
- None of the \$50,000 salary EO paid the President for 2002 constituted inurement under Reg. 1.501(c)(3)-1(c)(2) or impermissible private benefit under Reg. 1.501(c)(3)-1(d)(1)(ii).
- The President was a disqualified person as to EO under IRC 4958(f)(1) and Reg. 53.4958-3.
- The \$2,500 constituted "wages" under IRC 3121(a) and IRC 3401(a). Consequently, EO is liable for the appropriate amount of employment taxes and income taxes on the \$2,500. IRC 3101; IRC 3102; IRC 3111; IRC 3402.
- As to the \$2,500, EO did not satisfy the written contemporaneous substantiation requirements under Reg. 53.4958-4(c)(3)(i)(A) because:
  - EO did not report the \$2,500 as compensation on an original Form 990, Form W-2 or Form 1099 for 2002, or on an amended Form 990, Form W-2 or Form 1099 that was filed before the start of the IRS examination for 2002.
  - The President did not report the \$2,500 as compensation on an original Form 1040 for 2002 or on an amended Form 1040 for 2002 that was filed before the earlier of:
    - The start of an IRS examination of the exempt organization for 2002, or

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## Example 5 – Noncountable Plan, Continued

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**IRS  
Examination,**  
(continued)

- The first written documentation by the IRS of a potential excess benefit transaction involving either the exempt organization or the disqualified person
- EO did not establish that its failure to report the \$2,500 as compensation on a timely filed Form 990, Form W-2 or Form 1099 was due to “reasonable cause” under Reg. 301.6724-1. Reg. 53.4958-4 (c)(3)(i)(B).
- EO did not establish other contemporaneous evidence demonstrating that through EO’s appropriate decision- making body or officer authorized to approved compensation, EO approved the payment of \$2,500 in accordance with established procedures. Reg. 53.4958-4 (c)(3)(ii).
- None of the \$50,000 salary the President received from EO for 2002 constituted an excess benefit transaction in 2002 under IRC 4958(c)(1) and Reg. 53.4958-4.
- All of the \$2,500 EO paid in 2002 to the President is treated as an “automatic” excess benefit transaction in 2002, despite the fact that the total economic benefits EO paid the President for 2002, \$52,500, was reasonable in relation to the value of the services EO received during 2002. IRC 4958(c)(1); Reg. 53.4958-4.
- The President is liable for the 25% excise tax under IRC 4958(a)(1) and the 200% excise tax under IRC 4958(b).
- If the President satisfies the requirements under IRC 4961 and IRC 4962, which includes correction of the excess benefit transaction, abatement of some or all of these taxes may occur.
- The President is not liable for the 100% penalty under IRC 6684. Although the President could not establish this excess benefit transaction was due to “reasonable cause” under Reg. 301.6684-1(b), under these facts, the IRS could not prove that it was “willful and flagrant” under Reg. 301.6684-1(c).

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## Example 5 – Noncountable Plan, Continued

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### IRS Examination, (continued)

- Since the President did not file Form 4720 reporting the \$2,500 as an excess benefit transaction, the IRS prepared a substitute Form 4720. IRC 6020(b); Reg. 301.6020-1(b)(2). Therefore, the President is liable for the penalty for failure to pay the applicable excise taxes under IRC 4958 on the \$2,500. IRC 6651(a)(3); Reg. 301.6651-1(a)(3).
  - All of the \$2,500 is includible the President’s gross income for 2002 under IRC 61(a) and the President is liable for the appropriate income taxes on this amount.
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### Conclusions

Since the written contemporaneous substantiation requirements were not satisfied, the \$2,500 is not treated as compensation for purposes of IRC 4958. Therefore, \$2,500 is treated as an “automatic” excess benefit transaction without regard to whether:

- The \$2,500 paid in 2002 is reasonable,
- The \$50,000 salary for 2002 is reasonable, or
- The aggregate economic benefits the EO paid in 2002, \$52,500, are reasonable.

Reg. 53.4958-4(c)(1).

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