

§§ 1.199-3(i)(7) and (8), and 1.199-5, William Kostak, (202) 622-3060; and concerning §§ 1.199-7(b)(4) and 1.199-8(i)(6), Ken Cohen, (202) 622-7790 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### Background

The final regulations (TD 9381) that are the subject of the correction are under section 199 of the Internal Revenue Code.

##### Need for Correction

As published, final regulations (TD 9381) contain an error that may prove to be misleading and is in need of clarification.

##### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

##### Correction of Publication

■ Accordingly, 26 CFR part 1 is corrected by making the following amendment:

#### PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read, in part, as follows:

*Authority:* 26 U.S.C. 7805 \* \* \*

■ **Par. 2.** Section 1.199-8 is amended by revising the last sentence of paragraph (i)(5) to read as follows:

##### § 1.199-8 Other rules.

\* \* \* \* \*

(i) \* \* \*

(5) \* \* \* A taxpayer may apply § 1.199-2(e)(2), 1.199-3(i)(7) and (8), and 1.199-5 to taxable years beginning after May 17, 2006, and before October 19, 2006, regardless of whether the taxpayer otherwise relied upon Notice 2005-14 (2005-1 CB 498) (see § 601.601(d)(2)(ii)(b) of this chapter), the provisions of REG-105847-05 (2005-2 CB 987), or §§ 1.199-1 through 1.199-8.

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##### LaNita Van Dyke,

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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Parts 1 and 53

[TD 9390]

RIN 1545-BE37

#### Standards for Recognition of Tax-Exempt Status if Private Benefit Exists or if an Applicable Tax-Exempt Organization Has Engaged in Excess Benefit Transaction(s)

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations that clarify the substantive requirements for tax exemption under section 501(c)(3) of the Internal Revenue Code (Code). This document also contains provisions that clarify the relationship between the substantive requirements for tax exemption under section 501(c)(3) and the imposition of section 4958 excise taxes on excess benefit transactions. These regulations affect organizations described in section 501(c)(3) of the Code and organizations applying for exemption as organizations described in section 501(c)(3) of the Code.

**DATES:** *Effective Date:* These regulations are effective March 28, 2008.

**FOR FURTHER INFORMATION CONTACT:** Galina Kolomietz, (202) 622-7971 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

##### Background

On September 9, 2005, a notice of proposed rulemaking (REG-111257-05, 2005-42 CB 759) clarifying the substantive requirements for tax exemption under section 501(c)(3) of the Code, and the relationship between the substantive requirements for tax exemption under section 501(c)(3) and the imposition of section 4958 excise taxes was published in the **Federal Register** (70 FR 53599). The IRS received several written comments responding to this notice. After consideration of all comments received, the proposed regulations under sections 501(c)(3) and 4958 are revised and published in final form. The major areas of comments and revisions are discussed in the following preamble. (See § 601.601(d)(2)(ii)(b)).

#### Explanation and Summary of Comments

##### *Private Benefit*

The proposed regulations added several examples to illustrate the

requirement in § 1.501(c)(3)-1(d)(1)(ii) that an organization serve a public rather than a private interest. The purpose of the examples is to illustrate that prohibited private benefit may involve non-economic benefits as well as economic benefits and that prohibited private benefit may arise regardless of whether payments made to private interests are reasonable or excessive.

One comment suggested that, rather than add three isolated examples on private benefit to the regulations, the IRS consider a broader revision of the regulations under section 501(c)(3) to provide a more detailed discussion of the underlying principles of the private benefit doctrine. In particular, this comment suggested that the regulations address the relative quantity of private benefit that could preclude exemption. The IRS and the Treasury Department are not revising the existing regulations under section 501(c)(3) at this time. The new examples in the proposed regulations clarify the principles of the private benefit doctrine under current law. In § 1.501(c)(3)-1(d)(1)(iii), Example 1 illustrates that private benefit may involve non-economic benefits. Example 2 illustrates that private benefit is inconsistent with tax-exempt status under section 501(c)(3) if it is substantial and not merely incidental to the accomplishment of the organization's exempt purposes. Example 3 illustrates that private benefit may exist even though the transaction is at fair market value. Moreover, these examples are intended to illustrate the principle that private benefit remains an independent basis for revocation even if it does not involve economic benefit or raise fair market value issues. Accordingly, these examples are adopted in final form without revision.

##### *Revocation Standards*

The proposed regulations provided guidance on certain factors that the IRS will consider in determining whether an applicable tax-exempt organization described in section 501(c)(3) that engages in one or more excess benefit transactions continues to be described in section 501(c)(3). The comments received in response to the proposed regulations are discussed below. Overall, the commentators reacted favorably to the factors set forth in the proposed regulations. The factors described in the proposed regulations are finalized without major revisions. The application of the factors is refined by the addition of a new example to the final regulations.

#### a. Interaction With Determination of Existence of Excess Benefit Transaction

Two comments suggested that the final regulations clarify the interaction between the determination of the organization's tax-exempt status and the determination of the existence of an excess benefit transaction. One of these comments specifically requested that the final regulations state that the IRS will not take any action to remove an organization's tax exemption on excess benefit transaction grounds while the IRS's determination of the existence of an excess benefit transaction is itself being contested in court. The final regulations do not adopt this comment. The determination of an organization's tax-exempt status and the determination of the existence of an excess benefit transaction are separate determinations, involving distinct parties, different legal elements, and separate processes, even though they may relate to the same facts.

#### b. Clarification of Terms

Two comments voiced the need to clarify the terms "significant" and "de minimis" as they are used in the proposed regulations. One of these comments suggested adding an example of a safe harbor based on specific amounts the IRS would consider clearly insignificant, perhaps as a percentage of overall expenditures. Because the determination of whether an activity or an amount is "significant" or "de minimis" depends on the facts and circumstances, the final regulations do not adopt this comment.

One comment suggested adding examples combining potential de minimis values with other abating or negative factors and/or examples containing values that are not de minimis. The final regulations contain a new example that illustrates the application of the revocation factors to an excess benefit transaction that is neither significant in comparison to the size and scope of the organization's exempt activities nor de minimis.

One comment requested clarification of the term "repeated" as used in Example 3 of § 1.501(c)(3)-1(g) of the proposed regulations. The term was used in that example to correspond to the third factor in the proposed regulations, which looked to "whether the organization has been involved in repeated excess benefit transactions." In response to this comment, the third factor of the proposed regulations is revised to substitute the term "multiple" for the word "repeated." The term "multiple" refers to both (1) repeated instances of the same (or

substantially similar) excess benefit transaction, regardless of whether the transaction involves the same or different persons; and (2) the presence of more than one excess benefit transaction, regardless of whether the transactions are the same or substantially similar and regardless of whether they involve the same or different persons.

Another comment requested guidance regarding when the IRS would consider the presence of a single excess benefit transaction to jeopardize an organization's tax-exempt status. Because such a determination would depend on the facts and circumstances, the final regulations do not adopt the comment.

#### c. Due Diligence and Safeguards

One comment requested that evidence that an organization's board of directors conducted appropriate due diligence or followed certain safeguards in connection with the excess benefit transaction be treated as a factor weighing in favor of continuing to recognize exemption. The IRS and the Treasury Department agree that the organization's reliance on objectively reasonable internal controls and procedures, such as the procedures for establishing a rebuttable presumption of reasonableness, in approving a transaction that is later determined to be an excess benefit transaction, should be treated as a factor weighing in favor of continuing to recognize exemption. Accordingly, the fourth factor under the proposed regulations is revised to make clear that implementation by an organization of safeguards that are reasonably calculated to prevent excess benefit transactions will be treated as a factor weighing in favor of continuing to recognize exemption regardless of whether such safeguards are implemented in direct response to the excess benefit transaction(s) at issue or as a general matter of corporate governance or fiscal management. Thus, an organization may be treated as having implemented safeguards reasonably calculated to prevent excess benefit transactions even though the organization is contesting the existence of the excess benefit transaction(s) at issue. An example is added to illustrate how implementation of safeguards, including preexisting safeguards, will be taken into account in determining whether to continue to recognize an organization's tax-exempt status.

One comment suggested that an organization's good faith attempt to establish a rebuttable presumption of reasonableness within the meaning of § 53.4958-6 be treated as a factor

weighing in favor of continuing to recognize exemption. Another comment suggested that a good faith attempt by an organization's board of directors to determine fair market value be treated as a factor precluding revocation even if the IRS disagrees with the board's fair market value analysis. The fourth factor, as revised in these final regulations, takes into account whether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions. This factor takes safeguards into account, regardless of whether they were implemented before or after an excess benefit transaction occurred. The comments raise the question of how this factor will apply where steps have been taken to avoid an excess benefit transaction, but nonetheless have failed to prevent the excess benefit transaction. The weight afforded to this particular circumstance will depend upon the specific facts and circumstances.

#### d. Requests for Additional Examples

Two comments suggested adding to the proposed regulations an example specifically addressing reasonable compensation. In response to these comments, the new example added by these final regulations addresses reasonable compensation.

One comment suggested that the regulations include examples involving health care organizations. The IRS and the Treasury Department note that the application of sections 501(c)(3) and 4958 to health care organizations is not unique. The examples in these regulations, although not specifically involving health care organizations, apply to health care organizations in the same manner as they apply to other organizations described in section 501(c)(3).

One comment criticized the examples in the proposed regulations as too "black-and-white" and suggested that the regulations be supplemented with examples that discuss less clear facts. Specifically, this comment requested guidance on situations involving more than de minimis amounts in which an applicable tax-exempt organization does not seek correction from the disqualified person involved. The new example added by these final regulations illustrates that, in some situations, even in the absence of correction of non-de minimis excess benefit transactions, an organization may retain its tax-exempt status if the other factors, in combination, warrant continued exemption. Under the fifth factor, the IRS will take into account the organization's good faith with respect to

correction. Accordingly, the reasons behind the organization's failure to seek correction will be examined.

One comment suggested adding an example that would illustrate what factors, in addition to post-audit correction, would be sufficient to avoid revocation. The example that has been added illustrates a case where factors other than correction support continued exemption. The IRS and the Treasury Department may consider publication of future guidance on the application of the factors based on other specific fact patterns that the IRS encounters in the course of tax administration.

One comment requested adding an example discussing the effect of "automatic excess benefit transactions" that are not de minimis on the organization's tax-exempt status. The term "automatic excess benefit transaction" refers to a transaction in which a disqualified person provides services to an organization and receives economic benefits from the organization that are not substantiated, contemporaneously and in writing, as compensation within the meaning of § 53.4958-4(c). After the enactment of the Pension Protection Act of 2006, Public Law 109-280 (120 Stat. 780 (2006)), the term "automatic excess benefit transaction" also refers to any grant, loan, compensation or other similar payment from a donor advised fund to a donor or donor advisor with respect to such fund and from a supporting organization to any of its disqualified persons. See section 4958(c)(2) and (3). Although not in the context of an automatic excess benefit transaction, the new example in the final regulations involves an excess benefit transaction that is not de minimis.

#### e. Removal of Disqualified Person

One comment suggested that the regulations address whether and under what circumstances removal of a disqualified person may be necessary to avoid revocation. The new example added by these final regulations illustrates that removal of a disqualified person is not a necessary condition for continued exemption. In the example, the organization implemented safeguards designed to prevent future excess benefit transactions involving the same disqualified persons.

#### f. Best Practices

One comment described specific actions that boards of applicable tax-exempt organizations should be required to take to improve governance and to prevent excess benefit transactions at their organizations. This

comment was not adopted because the purpose of these regulations is to set forth an analytical framework for determining whether to revoke tax-exempt status if an organization engages in one or more excess benefit transactions.

#### Special Analyses

It has been determined that this regulation is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation, and because this regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on business.

#### Drafting Information

The principal authors of these regulations are Galina Kolomietz and Phyllis Haney, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

#### List of Subjects

##### 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

##### 26 CFR Part 53

Excise taxes, Foundations, Investments, Lobbying, Reporting and recordkeeping requirements.

#### Amendments to the Regulations

■ Accordingly, 26 CFR parts 1 and 53 are amended as follows:

#### PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read, in part, as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*

■ **Par. 2.** Section 1.501(c)(3)-1 is revised by:

■ 1. Redesignating paragraph (d)(1)(iii) as paragraph (d)(1)(iv) and adding a new paragraph (d)(1)(iii).

■ 2. Redesignating paragraph (f) as paragraph (g) and adding a new paragraph (f).

The additions read as follows:

#### § 1.501(c)(3)-1 Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

\* \* \* \* \*

(d) \* \* \*  
(1) \* \* \*

(iii) *Examples.* The following examples illustrate the requirement of paragraph (d)(1)(ii) of this section that an organization serve a public rather than a private interest:

*Example 1.* (i) O is an educational organization the purpose of which is to study history and immigration. O's educational activities include sponsoring lectures and publishing a journal. The focus of O's historical studies is the genealogy of one family, tracing the descent of its present members. O actively solicits for membership only individuals who are members of that one family. O's research is directed toward publishing a history of that family that will document the pedigrees of family members. A major objective of O's research is to identify and locate living descendants of that family to enable those descendants to become acquainted with each other.

(ii) O's educational activities primarily serve the private interests of members of a single family rather than a public interest. Therefore, O is operated for the benefit of private interests in violation of the restriction on private benefit in paragraph (d)(1)(ii) of this section. Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

*Example 2.* (i) O is an art museum. O's principal activity is exhibiting art created by a group of unknown but promising local artists. O's activity, including organized tours of its art collection, promotes the arts. O is governed by a board of trustees unrelated to the artists whose work O exhibits. All of the art exhibited is offered for sale at prices set by the artist. Each artist whose work is exhibited has a consignment arrangement with O. Under this arrangement, when art is sold, the museum retains 10 percent of the selling price to cover the costs of operating the museum and gives the artist 90 percent.

(ii) The artists in this situation directly benefit from the exhibition and sale of their art. As a result, the sole activity of O serves the private interests of these artists. Because O gives 90 percent of the proceeds from its sole activity to the individual artists, the direct benefits to the artists are substantial and O's provision of these benefits to the artists is more than incidental to its other purposes and activities. This arrangement causes O to be operated for the benefit of private interests in violation of the restriction on private benefit in paragraph (d)(1)(ii) of this section. Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

*Example 3.* (i) O is an educational organization the purpose of which is to train individuals in a program developed by P, O's president. The program is of interest to academics and professionals, representatives

of whom serve on an advisory panel to O. All of the rights to the program are owned by Company K, a for-profit corporation owned by P. Prior to the existence of O, the teaching of the program was conducted by Company K. O licenses, from Company K, the right to conduct seminars and lectures on the program and to use the name of the program as part of O's name, in exchange for specified royalty payments. Under the license agreement, Company K provides O with the services of trainers and with course materials on the program. O may develop and copyright new course materials on the program but all such materials must be assigned to Company K without consideration if and when the license agreement is terminated. Company K sets the tuition for the seminars and lectures on the program conducted by O. O has agreed not to become involved in any activity resembling the program or its implementation for 2 years after the termination of O's license agreement.

(i) O's sole activity is conducting seminars and lectures on the program. This arrangement causes O to be operated for the benefit of P and Company K in violation of the restriction on private benefit in paragraph (d)(1)(ii) of this section, regardless of whether the royalty payments from O to Company K for the right to teach the program are reasonable. Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

\* \* \* \* \*

(f) *Interaction with section 4958—(1) Application process.* An organization that applies for recognition of exemption under section 501(a) as an organization described in section 501(c)(3) must establish its eligibility under this section. The Commissioner may deny an application for exemption for failure to establish any of section 501(c)(3)'s requirements for exemption. Section 4958 does not apply to transactions with an organization that has failed to establish that it satisfies all of the requirements for exemption under section 501(c)(3). See § 53.4958-2.

(2) *Substantive requirements for exemption still apply to applicable tax-exempt organizations described in section 501(c)(3)—(i) In general.* Regardless of whether a particular transaction is subject to excise taxes under section 4958, the substantive requirements for tax exemption under section 501(c)(3) still apply to an applicable tax-exempt organization (as defined in section 4958(e) and § 53.4958-2) described in section 501(c)(3) whose disqualified persons or organization managers are subject to excise taxes under section 4958. Accordingly, an organization will no longer meet the requirements for tax-exempt status under section 501(c)(3) if the organization fails to satisfy the

requirements of paragraph (b), (c) or (d) of this section. See § 53.4958-8(a).

(ii) *Determination of whether revocation of tax-exempt status is appropriate when section 4958 excise taxes also apply.* In determining whether to continue to recognize the tax-exempt status of an applicable tax-exempt organization (as defined in section 4958(e) and § 53.4958-2) described in section 501(c)(3) that engages in one or more excess benefit transactions (as defined in section 4958(c) and § 53.4958-4) that violate the prohibition on inurement under section 501(c)(3), the Commissioner will consider all relevant facts and circumstances, including, but not limited to, the following—

(A) The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred;

(B) The size and scope of the excess benefit transaction or transactions (collectively, if more than one) in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes;

(C) Whether the organization has been involved in multiple excess benefit transactions with one or more persons;

(D) Whether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions; and

(E) Whether the excess benefit transaction has been corrected (within the meaning of section 4958(f)(6) and § 53.4958-7), or the organization has made good faith efforts to seek correction from the disqualified person(s) who benefited from the excess benefit transaction.

(iii) All factors will be considered in combination with each other. Depending on the particular situation, the Commissioner may assign greater or lesser weight to some factors than to others. The factors listed in paragraphs (f)(2)(ii)(D) and (E) of this section will weigh more heavily in favor of continuing to recognize exemption where the organization discovers the excess benefit transaction or transactions and takes action before the Commissioner discovers the excess benefit transaction or transactions. Further, with respect to the factor listed in paragraph (f)(2)(ii)(E) of this section, correction after the excess benefit transaction or transactions are discovered by the Commissioner, by itself, is never a sufficient basis for continuing to recognize exemption.

(iv) *Examples.* The following examples illustrate the principles of paragraph (f)(2)(ii) of this section. For

purposes of each example, assume that O is an applicable tax-exempt organization (as defined in section 4958(e) and § 53.4958-2) described in section 501(c)(3). The examples read as follows:

*Example 1.* (i) O was created as a museum for the purpose of exhibiting art to the general public. In Years 1 and 2, O engages in fundraising and in selecting, leasing, and preparing an appropriate facility for a museum. In Year 3, a new board of trustees is elected. All of the new trustees are local art dealers. Beginning in Year 3 and continuing to the present, O uses a substantial portion of its revenues to purchase art solely from its trustees at prices that exceed fair market value. O exhibits and offers for sale all of the art it purchases. O's Form 1023, "Application for Recognition of Exemption," did not disclose the possibility that O would purchase art from its trustees.

(ii) O's purchases of art from its trustees at more than fair market value constitute excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these transactions are subject to the applicable excise taxes provided in that section. In addition, O's purchases of art from its trustees at more than fair market value violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. Beginning in Year 3, O does not engage primarily in regular and ongoing activities that further exempt purposes because a substantial portion of O's activities consists of purchasing art from its trustees and dealing in such art in a manner similar to a commercial art gallery. The size and scope of the excess benefit transactions collectively are significant in relation to the size and scope of any of O's ongoing activities that further exempt purposes. O has been involved in multiple excess benefit transactions, namely, purchases of art from its trustees at more than fair market value. O has not implemented safeguards that are reasonably calculated to prevent such improper purchases in the future. The excess benefit transactions have not been corrected, nor has O made good faith efforts to seek correction from the disqualified persons who benefited from the excess benefit transactions (the trustees). The trustees continue to control O's Board. Based on the application of the factors to these facts, O is no longer described in section 501(c)(3) effective in Year 3.

*Example 2.* (i) The facts are the same as in *Example 1*, except that in Year 4, O's entire board of trustees resigns, and O no longer offers all exhibited art for sale. The former board is replaced with members of the community who are not in the business of buying or selling art and who have skills and experience running charitable and educational programs and institutions. O promptly discontinues the practice of purchasing art from current or former trustees, adopts a written conflicts of interest policy, adopts written art valuation

guidelines, hires legal counsel to recover the excess amounts O had paid its former trustees, and implements a new program of activities to further the public's appreciation of the arts.

(ii) O's purchases of art from its former trustees at more than fair market value constitute excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these transactions are subject to the applicable excise taxes provided in that section. In addition, O's purchases of art from its trustees at more than fair market value violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. In Year 3, O does not engage primarily in regular and ongoing activities that further exempt purposes. However, in Year 4, O elects a new board of trustees comprised of individuals who have skills and experience running charitable and educational programs and implements a new program of activities to further the public's appreciation of the arts. As a result of these actions, beginning in Year 4, O engages in regular and ongoing activities that further exempt purposes. The size and scope of the excess benefit transactions that occurred in Year 3, taken collectively, are significant in relation to the size and scope of O's regular and ongoing exempt function activities that were conducted in Year 3. Beginning in Year 4, however, as O's exempt function activities grow, the size and scope of the excess benefit transactions that occurred in Year 3 become less and less significant as compared to the size and extent of O's regular and ongoing exempt function activities. O was involved in multiple excess benefit transactions in Year 3. However, by discontinuing its practice of purchasing art from its current and former trustees, by replacing its former board with independent members of the community, and by adopting a conflicts of interest policy and art valuation guidelines, O has implemented safeguards that are reasonably calculated to prevent future violations. In addition, O has made a good faith effort to seek correction from the disqualified persons who benefited from the excess benefit transactions (its former trustees). Based on the application of the factors to these facts, O continues to meet the requirements for tax exemption under section 501(c)(3).

*Example 3.* (i) O conducts educational programs for the benefit of the general public. Since its formation, O has employed its founder, C, as its Chief Executive Officer. Beginning in Year 5 of O's operations and continuing to the present, C caused O to divert significant portions of O's funds to pay C's personal expenses. The diversions by C significantly reduced the funds available to conduct O's ongoing educational programs. The board of trustees never authorized C to cause O to pay C's personal expenses from O's funds. Certain members of the board were aware that O was paying C's personal expenses. However, the board did not terminate C's employment and did not take any action to seek repayment from C or to prevent C from continuing to divert O's funds

to pay C's personal expenses. C claimed that O's payments of C's personal expenses represented loans from O to C. However, no contemporaneous loan documentation exists, and C never made any payments of principal or interest.

(ii) The diversions of O's funds to pay C's personal expenses constitute excess benefit transactions between an applicable tax-exempt organization and a disqualified person under section 4958. Therefore, these transactions are subject to the applicable excise taxes provided in that section. In addition, these transactions violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transactions occurred. However, the size and scope of the excess benefit transactions engaged in by O beginning in Year 5, collectively, are significant in relation to the size and scope of O's activities that further exempt purposes. Moreover, O has been involved in multiple excess benefit transactions. O has not implemented any safeguards that are reasonably calculated to prevent future diversions. The excess benefit transactions have not been corrected, nor has O made good faith efforts to seek correction from C, the disqualified person who benefited from the excess benefit transactions. Based on the application of the factors to these facts, O is no longer described in section 501(c)(3) effective in Year 5.

*Example 4.* (i) O conducts activities that further exempt purposes. O uses several buildings in the conduct of its exempt activities. In Year 1, O sold one of the buildings to Company K for an amount that was substantially below fair market value. The sale was a significant event in relation to O's other activities. C, O's Chief Executive Officer, owns all of the voting stock of Company K. When O's board of trustees approved the transaction with Company K, the board did not perform due diligence that could have made it aware that the price paid by Company K to acquire the building was below fair market value. Subsequently, but before the IRS commences an examination of O, O's board of trustees determines that Company K paid less than the fair market value for the building. Thus, O concludes that an excess benefit transaction occurred. After the board makes this determination, it promptly removes C as Chief Executive Officer, terminates C's employment with O, and hires legal counsel to recover the excess benefit from Company K. In addition, O promptly adopts a conflicts of interest policy and new contract review procedures designed to prevent future recurrences of this problem.

(ii) The sale of the building by O to Company K at less than fair market value constitutes an excess benefit transaction between an applicable tax-exempt organization and a disqualified person under section 4958 in Year 1. Therefore, this transaction is subject to the applicable excise taxes provided in that section. In addition, this transaction violates the proscription

against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transaction occurred. Although the size and scope of the excess benefit transaction were significant in relation to the size and scope of O's activities that further exempt purposes, the transaction with Company K was a one-time occurrence. By adopting a conflicts of interest policy and significant new contract review procedures and by terminating C, O has implemented safeguards that are reasonably calculated to prevent future violations. Moreover, O took corrective actions before the IRS commenced an examination of O. In addition, O has made a good faith effort to seek correction from Company K, the disqualified person who benefited from the excess benefit transaction. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

*Example 5.* (i) O is a large organization with substantial assets and revenues. O conducts activities that further its exempt purposes. O employs C as its Chief Financial Officer. During Year 1, O pays \$2,500 of C's personal expenses. O does not make these payments pursuant to an accountable plan, as described in § 53.4958-4(a)(4)(ii). In addition, O does not report any of these payments on C's Form W-2, "Wage and Tax Statement," or on a Form 1099-MISC, "Miscellaneous Income," for C for Year 1, and O does not report these payments as compensation on its Form 990, "Return of Organization Exempt From Income Tax," for Year 1. Moreover, none of these payments can be disregarded as nontaxable fringe benefits under § 53.4958-4(c)(2) and none consisted of fixed payments under an initial contract under § 53.4958-4(a)(3). C does not report the \$2,500 of payments as income on his individual Federal income tax return for Year 1. O does not repeat this reporting omission in subsequent years and, instead, reports all payments of C's personal expenses not made under an accountable plan as income to C.

(ii) O's payment in Year 1 of \$2,500 of C's personal expenses constitutes an excess benefit transaction between an applicable tax-exempt organization and a disqualified person under section 4958. Therefore, this transaction is subject to the applicable excise taxes provided in that section. In addition, this transaction violates the proscription against inurement in section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O engages in regular and ongoing activities that further exempt purposes. The payment of \$2,500 of C's personal expenses represented only a de minimis portion of O's assets and revenues; thus, the size and scope of the excess benefit transaction were not significant in relation to the size and scope of O's activities that further exempt purposes. The reporting omission that resulted in the excess benefit transaction in Year 1 occurred only once and

is not repeated in subsequent years. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

*Example 6.* (i) O is a large organization with substantial assets and revenues. O furthers its exempt purposes by providing social services to the population of a specific geographic area. O has a sizeable workforce of employees and volunteers to conduct its work. In Year 1, O's board of directors adopted written procedures for setting executive compensation at O. O's executive compensation procedures were modeled on the procedures for establishing a rebuttable presumption of reasonableness under § 53.4958-6. In accordance with these procedures, the board appointed a compensation committee to gather data on compensation levels paid by similarly situated organizations for functionally comparable positions. The members of the compensation committee were disinterested within the meaning of § 53.4958-6(c)(1)(iii). Based on its research, the compensation committee recommended a range of reasonable compensation for several of O's existing top executives (the Top Executives). On the basis of the committee's recommendations, the board approved new compensation packages for the Top Executives and timely documented the basis for its decision in board minutes. The board members were all disinterested within the meaning of § 53.4958-6(c)(1)(iii). The Top Executives were not involved in setting their own compensation. In Year 1, even though payroll expenses represented a significant portion of O's total operating expenses, the total compensation paid to O's Top Executives represented only an insubstantial portion of O's total payroll expenses. During a subsequent examination, the IRS found that the compensation committee relied exclusively on compensation data from organizations that perform similar social services to O. The IRS concluded, however, that the organizations were not similarly situated because they served substantially larger geographic regions with more diverse populations and were larger than O in terms of annual revenues, total operating budget, number of employees, and number of beneficiaries served. Accordingly, the IRS concluded that the compensation committee did not rely on "appropriate data as to comparability" within the meaning of § 53.4958-6(c)(2) and, thus, failed to establish the rebuttable presumption of reasonableness under § 53.4958-6. Taking O's size and the nature of the geographic area and population it serves into account, the IRS concluded that the Top Executives' compensation packages for Year 1 were excessive. As a result of the examination, O's board added new members to the compensation committee who have expertise in compensation matters and also amended its written procedures to require the compensation committee to evaluate a number of specific factors, including size, geographic area, and population covered by the organization, in assessing the comparability of compensation data. O's board renegotiated the Top Executives' contracts in accordance with the

recommendations of the newly constituted compensation committee on a going forward basis. To avoid potential liability for damages under state contract law, O did not seek to void the Top Executives' employment contracts retroactively to Year 1 and did not seek correction of the excess benefit amounts from the Top Executives. O did not terminate any of the Top Executives.

(ii) O's payments of excessive compensation to the Top Executives in Year 1 constituted excess benefit transactions between an applicable tax-exempt organization and disqualified persons under section 4958. Therefore, these payments are subject to the applicable excise taxes provided under that section, including second-tier taxes if there is no correction by the disqualified persons. In addition, these payments violate the proscription against inurement under section 501(c)(3) and paragraph (c)(2) of this section.

(iii) The application of the factors in paragraph (f)(2)(ii) of this section to these facts is as follows. O has engaged in regular and ongoing activities that further exempt purposes both before and after the excess benefit transactions occurred. The size and scope of the excess benefit transactions, in the aggregate, were not significant in relation to the size and scope of O's activities that further exempt purposes. O engaged in multiple excess benefit transactions. Nevertheless, prior to entering into these excess benefit transactions, O had implemented written procedures for setting the compensation of its top management that were reasonably calculated to prevent the occurrence of excess benefit transactions. O followed these written procedures in setting the compensation of the Top Executives for Year 1. Despite the board's failure to rely on appropriate comparability data, the fact that O implemented and followed these written procedures in setting the compensation of the Top Executives for Year 1 is a factor favoring continued exemption. The fact that O amended its written procedures to ensure the use of appropriate comparability data and renegotiated the Top Executives' compensation packages on a going-forward basis are also factors favoring continued exemption, even though O did not void the Top Executives' existing contracts and did not seek correction from the Top Executives. Based on the application of the factors to these facts, O continues to be described in section 501(c)(3).

(3) *Applicability.* The rules in paragraph (f) of this section will apply with respect to excess benefit transactions occurring after March 28, 2008.

\* \* \* \* \*

## PART 53—FOUNDATION AND SIMILAR EXCISE TAXES

■ **Par. 3.** The authority citation for part 53 continues to read, in part, as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*

■ **Par. 4.** In § 53.4958-2, paragraph (a)(6) is added to read as follows:

### § 53.4958-2 Definition of applicable tax-exempt organization.

(a) \* \* \*

(6) *Examples.* The following examples illustrate the principles of this section, which defines an applicable tax-exempt organization for purposes of section 4958:

*Example 1.* O is a nonprofit corporation formed under state law. O filed its application for recognition of exemption under section 501(c)(3) within the time prescribed under section 508(a). In its application, O described its plans for purchasing property from some of its directors at prices that would exceed fair market value. After reviewing the application, the IRS determined that because of the proposed property purchase transactions, O failed to establish that it met the requirements for an organization described in section 501(c)(3). Accordingly, the IRS denied O's application. While O's application was pending, O engaged in the purchase transactions described in its application at prices that exceeded the fair market values of the properties. Although these transactions would constitute excess benefit transactions under section 4958, because the IRS never recognized O as an organization described in section 501(c)(3), O was never an applicable tax-exempt organization under section 4958. Therefore, these transactions are not subject to the excise taxes provided in section 4958.

*Example 2.* O is a nonprofit corporation formed under state law. O files its application for recognition of exemption under section 501(c)(3) within the time prescribed under section 508(a). The IRS issues a favorable determination letter in Year 1 that recognizes O as an organization described in section 501(c)(3). Subsequently, in Year 5 of O's operations, O engages in certain transactions that constitute excess benefit transactions under section 4958 and violate the proscription against inurement under section 501(c)(3) and § 1.501(c)(3)-1(c)(2). The IRS examines the Form 990, "Return of Organization Exempt From Income Tax", that O filed for Year 5. After considering all the relevant facts and circumstances in accordance with § 1.501(c)(3)-1(f), the IRS concludes that O is no longer described in section 501(c)(3) effective in Year 5. The IRS does not examine the Forms 990 that O filed for its first four years of operations and, accordingly, does not revoke O's exempt status for those years. Although O's tax-exempt status is revoked effective in Year 5, under the *lookback* rules in paragraph (a)(1) of this section and § 53.4958-3(a)(1) of this chapter, during the five-year period prior to the excess benefit transactions that occurred in Year 5, O was an applicable tax-exempt organization and O's directors were disqualified persons as to O. Therefore, the transactions between O and its directors during Year 5 are subject to the

applicable excise taxes provided in section 4958.

\* \* \* \* \*

**Linda E. Stiff,**

*Deputy Commissioner for Services and Enforcement.*

Approved: March 19, 2008.

**Eric Solomon,**

*Assistant Secretary of the Treasury (Tax Policy).*

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## DEPARTMENT OF DEFENSE

### Office of the Secretary

#### 32 CFR Part 216

[DoD-2006-OS-0136]

RIN 0790-A115

#### **Military Recruiting and Reserve Officer Training Corps Program Access to Institutions of Higher Education**

**AGENCY:** Department of Defense.

**ACTION:** Final rule.

**SUMMARY:** The Department of Defense revises the current rule addressing military recruiting and Reserve Officer Training Corps program access at institutions of higher education. This final rule implements 10 U.S.C. 983, as amended by the Ronald W. Reagan National Defense Authorization Act for Fiscal Year 2005 (Pub. L. 108-375 (October 28, 2004)). As amended, 10 U.S.C. 983 clarifies access to campuses, access to students and access to directory information on students for the purposes of military recruiting, and now states that access to campuses and students on campuses shall be provided in a manner that is at least equal in quality and scope to that provided to any other employer. The prohibition against providing Federal funds when there is a violation of 10 U.S.C. 983 has an exception for any Federal funds provided to an institution of higher education, or to an individual, that are available solely for student financial assistance, related administrative costs, or costs associated with attendance. Such funds may be used for the purpose for which the funding is provided. A similar provision in section 8120 of the Department of Defense Appropriations Act of 2000 (Pub. L. 106-79; 113 Stat. 1260) has been repealed. This rule also rescinds the previous policy that established an exception that would limit recruiting on the premises of the covered school only in response to an expression of student interest when the

covered school certified that too few students had expressed interest to warrant accommodating military recruiters.

**DATES: Effective Date:** This rule is effective April 28, 2008.

**FOR FURTHER INFORMATION CONTACT:** Christopher Arendt, telephone: (703) 695-5529.

**SUPPLEMENTARY INFORMATION:** “Covered funds” is defined in 10 U.S.C. 983 to be any funds made available for the Departments of Defense, Transportation, Homeland Security, or National Nuclear Security Administration of the Department of Energy, the Central Intelligence Agency, or for any department or agency in which regular appropriations are made in the Departments of Labor, Health and Human Services, Education, and Related Agencies Appropriations Act. None of these covered funds may be provided by contract or grant to a covered school (including any subelement of a covered school) that has a policy or practice (regardless of when implemented) that either prohibits, or in effect prevents, the Secretary of Defense from establishing or operating a Senior Reserve Officer Training Corps (ROTC) at that covered school (or any subelement of that covered school); or that either prohibits, or in effect prevents, a student at that covered school (or any subelement of that covered school) from enrolling in a ROTC unit at another institution of higher education. The Federal law further provides similar sanctions against these covered funds being provided to a covered school (or any subelement of a covered school) that has a policy or practice (regardless of when implemented) that either prohibits, or in effect prevents, the Secretary of a Military Department or Secretary of Homeland Security from gaining access to campuses, or access to students (who are 17 years of age or older) on campuses, for purposes of military recruiting, where such policy or practice denies the military recruiter access that is at least equal in quality and scope to the access to campuses and students provided to any other employer; or access to student directory information pertaining to the students’ names, addresses, telephone listings, dates and places of birth, levels of education, academic majors, degrees received, and the most recent educational institution enrolled in by the student.

The meaning and effect of the term “equal in quality and scope” was explained in the U.S. Supreme Court decision in *Rumsfeld v. Forum for Academic and Institutional Rights, Inc.*,

126 S. Ct. 1297 (2006). The term means the same access to campus and students provided by the school to any other nonmilitary recruiters or employers receiving the most favorable access. The focus is not on the content of a school’s recruiting policy, but instead on the result achieved by the policy and compares the access provided military recruiters to that provided other recruiters. Therefore, it is insufficient to comply with the statute (10 U.S.C. 983) if the policy results in a greater level of access for other recruiters than for the military.

As an exception to the above rule, any Federal funding provided to a covered school or to an individual that is available solely for student financial assistance, related administrative costs, or costs associated with attendance, may be used for the purpose for which the funding is provided.

The Department of Defense drafted this rule in consultation with other Federal agencies, including the Departments of Education, Labor, Transportation, Health and Human Services, Homeland Security, Energy, and the Central Intelligence Agency. Agencies affected by this rule will continue to coordinate with other organizations as they implement their provisions. In addition, comments submitted by institutions and individuals following the publication of the proposed rule on May 7, 2007 (72 FR 25713) were considered and are reflected in this final rule.

This rule defines the criteria for determining whether an institution of higher education has a policy or practice prohibiting or preventing the Secretary of Defense from maintaining, establishing, or efficiently operating a Senior ROTC unit; or has a policy of denying military recruiting personnel access that is at least equal in quality and scope to the access to campuses and students provided to any other employer, or access to directory information on students. Pursuant to 10 U.S.C. 983 and this, institutions of higher education having such policies or practices are ineligible for certain Federal funding.

The criterion of “efficiently operating a Senior ROTC unit” refers generally to an expectation that the ROTC Department would be treated on a par with other academic departments; as such, it would not be singled out for unreasonable actions that would impede access to students (and vice versa) or restrict its operations.

This rule also defines the procedures that would be followed in evaluating reports that a covered school has not met requirements defined in this rule.