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Private Inurement and Excess Benefit Transactions

Exempt organizations must be organized and operated so that *no part* of their net earnings inure (i.e., accrue), directly or indirectly, to the benefit of any *private shareholder* or individual. Whether there is private inurement depends on the economic reasonableness of transactions between the organization and insiders.

A *private shareholder or individual* is defined as a person who has a personal and private interest in the activities of the organization (i.e., an insider). Organization insiders are normally in control of the decisions of the entity and can include trustees, directors, officers, members, founders, and even major contributors or other third parties. Insiders cannot receive a distribution of funds from the organization except as reasonable payment for goods and services. The phrase *no part* means that the level of inurement is not material. Therefore, any inurement (regardless of the amount) could endanger an organization's exempt status.

Troublesome Transactions

Organizations have lost their exempt status because of private inurement related to unreasonable compensation, unreasonable fringe benefits, improper (generally personal) use of an organization's assets, forgiveness of indebtedness owed by insiders, personal expenses being paid by the organization, low-interest or unsecured loans to insiders, unreasonable housing allowances, other than arm's-length purchases, sales, or property rental between the organization and insiders, organization's purpose to overturn legislation benefitting primary donor with only incidental community benefit, and benefits available only to those participating in the organization's fundraising programs. In addition, exempt status will be denied to an organization that is operated primarily to serve an individual's private interests. This includes a church organization that uses its revenue to lease church service space from one of the organization's officers.

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Intermediate Sanctions—Punishment without Revocation

While the IRS can, it is often reluctant to, revoke a Section 501(c)(3) organization's tax-exempt status because of private inurement. Revocation is typically reserved for extreme cases as the IRS considers the potential harm, especially for large organizations, revocation will cause the community being served by the organization. Consequently, the *intermediate sanctions* provisions were enacted to provide the IRS the means to punish private inurement (i.e., the *excess benefit*) without revoking exemption. The excise taxes are generally the sole sanction imposed unless the private inurement (the excess benefit) is so great that the organization is no longer operating as a charitable organization.

Testing for excess benefit is fairly straightforward and the definitions are key. An excess benefit has occurred if all of the following are answered "Yes:"

1. Is this organization an *applicable tax-exempt organization*?
2. Is the person involved a *disqualified person*?
3. Is the transaction an *excess benefit transaction*?

Applicable tax-exempt organization (ATEO). An ATEO includes Section 501(c)(3) public charities, Section 501(c)(4) organizations, and Section 501(c)(29) organizations including an organization exempt under these sections at any time during a five-year period ending on the date of the EBT.

Disqualified persons. The term *persons* includes entities as well as individuals. Disqualified persons include the following:

1. Any person who, at any time during the five-year period ending on the date of the transaction involved, was in a position to exercise substantial influence (either formally or informally) over the affairs of an organization (including a voting member of the governing body, president, chief executive officer, chief operations officer, treasurer, and chief financial officer).
2. A family member of any such individual (described in item 1).
3. An entity in which individuals described in the preceding categories own more than a 35% interest.

The following persons are considered disqualified persons for the following organizations, along with certain family members and 35% controlled entities associated with them.

- For a transaction involving a donor advised fund, a donor or donor advisor of that donor advised fund.
- For a donor advised fund sponsoring organization, an investment advisor of the sponsoring organization.
- For a supported organization of a Section 509(a)(3) supporting organization, the disqualified persons of the Section 509(a)(3) supporting organization.

EBTs and automatic EBTs. An *excess benefit* is generally the amount by which the economic benefit provided to a disqualified person by an ATEO exceeds the value of the consideration given by the disqualified person. However, in the following three situations, which are deemed *automatic EBTs*, the entire amount paid to a disqualified person is an excess benefit.

1. *Unreported compensation*. An economic benefit that should be treated as compensation but is not is considered an automatic excess benefit. This is true even though total compensation would have been reasonable if the economic benefit had been included in compensation. An economic benefit will not be treated as consideration for services unless a clear indication of intent to do so exists. Therefore, an economic benefit intended to be compensation must be approved in accordance with the organization's policies and treated accordingly in its books, records, and relevant tax returns.
2. *Donor advised fund payments*. Any grant, loan, payment of compensation, or other similar payments (such as an expense reimbursement) from a donor advised fund (DAF) to a disqualified person is automatically treated as an excess benefit in its entirety.
3. *Supporting organization payments*. The same types of payments that are automatic EBTs if made by a DAF are also automatic excess benefits in their entirety if made by a supporting organization to certain specified persons, as well as any loan by a supporting organization to a disqualified person. The specified persons are a substantial contributor to the supporting organization; a member of his or her family; and a corporation, partnership, trust, or estate in which such persons have more than a 35% interest. An individual's family includes his or her spouse, his or her siblings and their spouses, ancestors, and descendants through great-grandchildren and their spouses.

Excise tax. Under IRC Sec. 4958, any disqualified person who benefits from an EBT with an ATEO is liable for a 25% tax on the excess benefit. The disqualified person is also liable for a 200% tax on the excess benefit if the excess benefit is not corrected by a certain date. Also, organization managers who participate in an EBT knowingly, willfully, and without reasonable cause are liable for a 10% tax on the excess benefit, not to exceed $20,000 for all participating managers on each transaction.

Correcting an EBT. An EBT must be corrected by a disqualified person during the taxable period in order to prevent the 200% tax under IRC Sec. 4958(b). The taxable period begins on the date the transaction occurs and ends on the earlier of the date the statutory notice of deficiency is issued or the Section 4958 taxes are assessed. Correction (i.e., undoing the excess benefit) is accomplished by the payment of a correction amount. The correction amount equals the sum of the excess benefit, plus interest, calculated by using a rate no lower than the applicable federal rate, compounded annually from the date the transaction occurred to the date of correction.

The correction amount typically must be paid in cash or cash equivalents (but not a promissory note). However, the disqualified person can pay it by returning specific property previously transferred in the EBT, provided this is acceptable to the organization.

IRS Considerations for Revocation when EBTs are Discovered

When IRC Sec. 4958 excise taxes are imposed, the IRS will also consider whether it is appropriate to seek revocation of the organization's exemption. The IRS considers the following factors in determining whether a Section 501(c)(3) organization continues to qualify for exempt status when excise taxes are imposed due to an EBT:

1. The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the EBT occurred.
2. The size and scope of the EBTs in relation to the organization's regular and ongoing activities that further its exempt purposes.
3. Whether the organization has been involved in repeated EBTs with one or more persons.
4. Whether the organization has implemented safeguards that are reasonably calculated to prevent EBTs.
5. Whether the EBT has been corrected or, if not, the organization has made good faith efforts to seek recovery from the disqualified persons who received the excess benefit.

All the factors will be considered in combination, some being of lesser or greater importance, depending on the particular situation. Discovery and correction of an EBT by an organization before discovery by the IRS will weigh strongly in favor of continuing exempt status. Conversely, correction of an EBT after discovery by the IRS will not be a sufficient reason alone to continue exempt status.

Central themes. There are two central themes reflected in the regulation examples:

1. When an organization engages in repeated transactions that are collectively significant in relation to the size and scope of ongoing exempt activities and the organization knows or should know the transactions are EBTs but does nothing to prevent future occurrences, the IRS will seek to revoke its exemption.
2. The IRS will likely preserve the tax exemption of an organization that, upon discovering it has been a party to EBTs, takes immediate action to prevent future occurrences. Appropriate corrective steps may include discontinuing ongoing EBTs; replacing some or all of its governing body with independent members; adopting a formal conflict of interest policy; adopting review procedures for the types of transactions that were EBTs; and making a good faith attempt to correct the EBT (i.e., recover the excess benefit from the disqualified person or persons).

Operating test. The organization will not satisfy the test of operating exclusively for an exempt purpose if more than an insubstantial part of its activities is for a purpose other than to further its exempt function(s). If an activity serves both exempt and nonexempt purposes, the exempt purpose must be the dominant purpose. Any private inurement or private benefit does not further an exempt purpose; but not all nonexempt purpose activities result in private inurement.

Note: Conducting the activity, rather than using the proceeds raised from it, must further the organization's exempt purpose.

Practical Consideration:

Decision makers need to have private inurement and excess benefit issues front and center of mind when considering an organization's activities and transactions (and reviewing the annual tax return) to avoid jeopardizing exempt status or incurring excise tax on EBTs. Contemporaneous documentation of the values in transactions can go a long way in defending against future IRS challenges.

Tax Brief

DISASTER RELIEF FOR TEXAS WINTER STORM VICTIMS. The IRS announced that victims of the severe winter storms in Texas that began February 11, 2021, will have until June 15, 2021, to file various tax returns and make tax payments. Taxpayers in other states impacted by these storms that receive similar FEMA disaster declarations will automatically receive the same filing and payment relief. The additional time to file applies to exempt organizations that have a return due on May 17, 2021. The IRS automatically identifies taxpayers located in the covered disaster area and applies filing and payment relief. However, affected taxpayers who reside or have a business located outside the covered disaster area should call the IRS disaster hotline at 866-562-5227 to request this tax relief. (IR-2021-43 and TX-2021-02)

AICPA Professional Ethics Division Reports on Audit Quality Deficiencies

The AICPA Professional Ethics Division conducts technical reviews of engagements that are subjects of investigations. The Division published a report, as of December 31, 2019, highlighting quality issues noted in the technical reviews they performed over the last two years. In that time, they completed 569 investigations, including 140 government, not-for-profit, and single audit engagements.

They noted several areas of concern that are likely areas where audit quality can continue to be improved. The AICPA intends for practitioners to use this report to identify areas of potential risk in their practices, better understand and comply with the AICPA *Code of Professional Conduct*, and avoid potential ethics violations.

This article covers many common issues that auditors should be aware of as they transition into the primary audit season for many nonprofit organizations.

Practical Consideration:

The complete report is available on the AICPA website at **www.aicpa.org/content/dam/aicpa/interestareas/professionalethics/resources/tools/downloadabledocuments/common-deficiencies-report-govt-and-nfp-final.pdf**. The report notes that the investigations stem from referrals from state and federal regulatory agencies. Because there is a time lag due to the referral and investigation process, some of the findings are from audits performed during 2015–2017. However, the report notes that these areas of quality concern continue to exist.

Audit Deficiencies

Evidence and Documentation. Deficiencies in obtaining sufficient appropriate audit evidence and documentation were the most frequent audit quality issues across all engagements.

Single Audit. The following deficiencies were noted specifically for single audits:

- All major programs not accurately identified or tested due to improperly classifying an entity as a low-risk auditee.
- Failure to test, or document the testing of, the operating effectiveness of internal controls over compliance and the testing of compliance for all compliance requirements subject to audit that are direct and material to the major program.
- Inadequate evaluation of the risk of material noncompliance and failure to document how risk assessment of material noncompliance was applied to the audit procedures performed.
- For sampling:
  - Sampling methodology not documented.
  - Sample size not appropriate based on the risk assessment of material noncompliance.
  - Selecting from an inappropriate population.

Failure to Exercise Due Professional Care. Inconsistencies between the financial statements and notes was the most common example of this failure.

Inadequately Documenting Independence Required by *Government Auditing Standards*. Failure to document the auditor's evaluation of management's ability to oversee nonaudit services performed, including designating an employee with suitable skills, knowledge, or experience (SKE), was the most frequent deficiency in this category.

Other Audit Deficiencies. Other deficiencies included the following:

- Failure to undergo a peer review required by the AICPA, state CPA society, state board, or *Government Auditing Standards*.
- Lack of competence to complete the audit under professional standards.
- Noncompliance with CPE requirements outlined in *Government Auditing Standards*.

Reporting, Presentation, and Disclosure Deficiencies

Deficiencies relating to reporting, presentation, and disclosures included the following:

- Auditor's reports were not in accordance with professional standards, including requirements relating to modified opinions, responsibility for supplementary information, dual-dates, and group audits. There were also failures to comply with AU-C 700.

- Financial statement errors included:
  - cash flow statements with incorrect classification or presentation.
  - comparative financial information inaccurately reported or presented.
  - disclosure issues in a number of areas including post-retirement benefits, investments, capital assets, debt service, leases, related parties, fair value, accounts receivable, inter/intrafund balances, and subsequent events.
- Financial statement errors specific to nonprofit organizations included failure to:
  - report expenses by functional classification.
  - present expenses by natural classification in the statement of functional expenses.
  - disclose the nature and amounts of net assets with donor restrictions.
  - provide required disclosures for endowments.
- Incomplete schedule of expenditures of federal awards.
- Inaccurate and/or incomplete findings in the schedule of findings and questions costs.
- Inconsistencies in deficiencies identified in the schedule of findings and questioned costs and in the auditor's reports on the financial statements, internal control over financial reporting, internal control over compliance, compliance for major federal programs, and compliance with provisions of laws, regulations, contracts, and award agreements.

Firm Management Issues

Deficiencies relating to firm management issues included the following:

- The firm's peer review was not current.
- The staff was not in compliance with CPE requirements.

Advice for Improvement

Based on the items noted in this article, there are many areas that can be improved upon when it comes to audit quality. Please consider these areas and issues as you plan and perform your next audit and renew your commitment to audit quality.

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FASB Project—Consolidation of a Nonprofit Entity by a For-Profit Sponsor

At its October 21, 2020, meeting, the FASB added a narrow-scope project to its technical agenda to address whether a for-profit sponsor should consolidate a nonprofit entity and to develop consolidation guidance in Topic 810, *Consolidation*. The Board plans to begin deliberations on this issue at a future meeting.

Genesis of the Project

The genesis of the project was an agenda request from Ernst & Young LLP in May 2020. They raised the question of how a for-profit entity that sponsors a tax-exempt charitable foundation should evaluate whether it has a controlling financial interest—by owning a majority voting interest, sole corporate membership, or some other means—that would require it to consolidate the nonprofit entity when it does not have a claim on the nonprofit entity's assets because of restrictions under Section 501(c)(3) of the Internal Revenue Code. The agenda request noted there may be other situations where nonprofit entities are established by for-profit entities, including homeowners' associations and political action committees.

Practical Consideration:

Information about this project is available on the FASB's website at **www.fasb.org/jsp/FASB/FASBContent_/ProjectUpdateExpandPage&cid=1176175469641#**.

Current Practice

There's no specific guidance for this fact pattern in Topic 810 of the Codification. In practice, entities apply either FASB ASC 958-810, *Not-For-Profit Entities—Consolidation*, or proposed consolidation guidance that's not yet final. As a result, there's diversity in consolidation practice. This project will develop specific guidance for this fact pattern in Topic 810 and the FASB staff will

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evaluate alternatives to consolidation. The Board hasn't yet issued an exposure draft.

We Want Your Financial Statements!

We have begun work on the 2021 edition of *PPC's Nonprofit Financial Illustrations and Trends (Nonprofit Trends)* and are on the lookout for new illustrative financial statements of nonprofit organizations. We are especially interested in financial statements for organizations that have implemented new accounting standards. We ask that the financial statements include note disclosures and *not* be for governmental units.

To comply with AICPA or state ethics requirements, you may need to obtain permission from your client before submitting financial statements for consideration. We will carefully edit any financial statements to obscure the name and location of the organization and other identifying information. If your submission is selected for inclusion in the 2021 edition of *Nonprofit Trends*, you will receive a free copy of that edition plus *PPC's Guide to Nonprofit GAAP* when they are available in the fall.

Financial statements may be submitted by attaching the files to an email and sending to **Checkpoint.PPC.NPT@thomsonreuters.com**.

Auditing Brief

CORRECTING AMENDMENTS TO UNIFORM GUIDANCE REVISIONS RELEASED. On August 13, 2020, the OMB published the final revisions to sections of Title 2 of the Code of Federal Regulations (CFR) Subtitle A—*OMB Guidance for Grants and Agreements*, including *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) located in 2 CFR part 200. Those revisions are covered in the 2020 edition of *PPC's Guide to Single Audits* and the upcoming 2021 editions of *PPC's Guide to Audits of Nonprofit Organizations* and *PPC's Guide to Audits of Local Governments*. On February 22, 2021, the OMB released correcting amendments to the final revisions. Those amendments corrected specific citations of sections and laws, added clarifying language to the revisions, and added the definition of *federal awarding agency*. The correcting amendments are effective upon issuance.

You can access the correcting amendments at **www.govinfo.gov/content/pkg/FR-2021-02-22/pdf/2021-02969.pdf?utm_campaign=subscription+mailing+list&utm_source=federalregister.gov&utm_medium=email**. The eCFR, at **ecfr.federalregister.gov/current/title-2/subtitle-A/chapter-II/part-200**, has been updated to reflect the amendments.