



Chapter 8

Did the Filer Engage in any Self-Dealing or Excess Benefit Transactions During the Year?

The IRS and state charity bureaus are the government agencies that provide general regulatory oversight over the nonprofit and tax-exempt sector. A primary concern of these agencies is to assure that nonprofit organizations are not used by those who control them to improperly transfer their assets to private interests in circumstances in which these assets should have been used to further the exempt purposes of the organizations. An example of such a transaction might be the sale by a board member of property he owns to the nonprofit organization on whose board he sits at a price in excess of its fair market value or the furnishing of services by the filer to a board member without charge or at a price below their market value.

These transactions may be generally described as self-dealing. (Thus, a board member in effect deals with himself when his board buys from him.) It is likely that an interested reader might be as concerned about these transactions as regulators.

These self-dealing transactions are also called excess benefit transactions and, as will be discussed below, include the payment of compensation to a key employee (say, the executive director) far in excess of what others in like positions are being paid.

Before proceeding it should be kept in mind that many self-dealing transactions may be advantageous to the filer. For example, rather than the sale by a board member of property he owns to the nonprofit organization on whose board he sits at a price in excess of its fair market value (which might be called a "malign" self-dealing transaction), the sale might be *below* fair market value to the advantage of the filer (which might be called a "benign" self-dealing transaction).

To begin an inquiry into this topic, one looks to Questions 25 a and b, 26, 27 and 28 of Part IV (Checklist of Required Schedules) at page 4 of the Form 990 proper. If any of these questions are answered "Yes," attention should be paid. (If they are all answered "No," then one may assume that probably there are no problems relating to self-dealing or excessive compensation.) When any of these questions are answered "Yes," the filer is required to complete some part of Schedule L.

Question 28 (on page 4) is the most general. Question 28a asks whether during the period covered any current (or former¹) officer, director or key employee² had a business relationship with the filer (other than as an officer, director or key employee).³ If the question is answered "Yes," the filer is required to complete Part IV of Schedule L.

Part IV of Schedule L elicits the following information:

- The name of the officer, director or key employee (referred to as the "interested person") is set out at Column a.
- The relationship between the interested person and the filer (e.g., director of the organization) is reported at Column b.
- The amount of the transaction is set out at Column c. The amount needs to be fairly substantial to be reported. Generally all payments during the year from a single transaction between an interested person and the filer need to be reported only if they exceed the greater of \$10,000 or 1% of the filer's total revenues. And in the case of multiple transactions with an interested person (all less than \$10,000) the amount must be reported only if the aggregate exceeds \$100,000.
- A description of the transaction is reported at Column d. The Instructions to Schedule L give as examples of such transactions the rental of property or the sale of assets. Recently a new Part V has been added to Schedule L where

¹ See Chapter 6 on the relevance of inquiries about former directors, etc.

² Generally the term "key employee" is defined as those who are not officers (or directors) who make over \$150,000 a year and have significant management responsibilities. See Chapter 6 for a further definition of the term "key employee."

³ Question 28b asks whether during the period covered any current (or former) officer, director or key employee had a family member who had a direct or indirect business relationship with the filer. If the question is answered "Yes," the filer is required to complete Part IV of Schedule L. Question 28c asks whether during the period covered any current (or former) officer, director or key employee served as an officer, director, trustee, key employee, partner, or member of an entity (or a shareholder of a professional corporation) doing business with the filer. If the question is answered "Yes," the filer is required to complete Part IV of Schedule L.

the filer can provide additional information to questions on Schedule L.⁴ It is here that the filer is given the opportunity to explain whether a transaction was advantageous or disadvantageous to the filer. For example, a sale by an interested person (e.g., a director) might have been below market value and thus advantageous to the filer and this would be obvious interest to the reader. Of course, the filer may not have explained the transaction. Doing so is optional. If the amount reported at Column c is large, and nothing is reported at Part V, it may motivate the reader to make further inquiry to find out whether the transaction was favorable (benign) or unfavorable (malign)⁵ to the filer.

- Finally Column e of Part IV asks whether part or all of the consideration paid by the filer to an interested person was based on a percentage of revenues of the organization. The Instructions give an example of a management fee based on a percentage of revenues of the filer. While arrangements where consideration is based on a percentage of the filer's revenues can be entirely acceptable, this is an area where abuse can occur and the reader may want to seek further information.

We now consider the other questions mentioned above. Question 25a of Part IV on page 4 asks whether the filer engaged in an excess benefit transaction with a disqualified person and if the answer is "Yes" requires the filer to complete Part I of Schedule L. "Disqualified persons" are persons like directors, officers and key employees or persons with substantial influence over the filer. An excess benefit transaction, generally, is one where a disqualified person receives more from the filer (say, compensation) than the worth of what s/he gave back in return (say, services). These transactions are addressed under section 4958 of the Code. See the Expansion on Section 4958. Question 25b asks whether the filer became aware that it had engaged in an excess benefit transaction with a disqualified person in a prior year. As excess benefit transactions are impermissible and reflect abuse, if either of these sub-questions is answered "Yes," the reader

⁴ Here is what the Instructions to Part V say in part: "Use Part V if the organization needs additional space to explain a transaction or provide additional information."

⁵ If the transaction was unfavorable to the filer, it may have been an excess business transaction and reported at Part I. See Expansion on section 4958 where excess business transactions are explained. It may, however, be doubted that a filer would report a transaction as an excess benefit transaction as such transactions are penalized and are in some sense unlawful and so the transaction would likely be reported at Part IV and nothing would be said about it at Part V.

should take note. And if either of these sub-questions is answered "Yes," the filer must complete Part I of Schedule L. Line 1 Column a of Part I on Schedule L lists the name of the disqualified person and Column b elicits the description of the excess benefit transaction. Column c asks whether the excess benefit transaction has been corrected (a yes and no box are provided). If an excess benefit transaction has occurred, the disqualified person, to avoid a very large tax, must correct the transaction by, in effect, giving the excess amount back to the filer. Line 2 reports the tax imposed on the disqualified person and Line 3 reports the amount of tax, if any, reimbursed by the filer.⁶

Question 26 asks whether a loan was made to or by the filer to or by a current (or former) officer, director, key employee, highly compensated employee⁷ or disqualified person⁸ as of the end of the filer's tax year. If so, Part II of Schedule L, eliciting information about the loan, is to be completed. Some states prohibit loans to directors and employees (e.g., NY) and others do not. In any event, the reader may raise an eyebrow if the question is answered "Yes."⁹

⁶ The reimbursement of a section 4958 tax is itself an excess benefit transaction.

⁷ Generally highly compensated employees are those employees (other than directors, officers, or key employees) who are among the five highest paid employees who received reportable compensation of more than \$100,000 from the filer or related organizations. See Chapter 6 for a more complete definition of "highly compensated employee."

⁸ See discussion above regarding Question 25 and excess benefit transaction for the definition of "disqualified person."

⁹ Question 27 asks whether the filer provided a grant or other assistance regardless of amount to an officer, director, or key employee or substantial contributor during the filer's tax year. Other assistance includes the provision of goods, services or the use of facilities. A substantial contributor generally is one who contributed at least \$5,000 during the filer's tax year. If Question 27 is answered "Yes," the filer is to complete Schedule L, Part III.