

Panel on the Nonprofit Sector

Convened by INDEPENDENT SECTOR

Work Group Recommendations to the Panel on the Nonprofit Sector Posted for Public Comment January 24, 2005

#8: Penalty Tax on Self-Dealing

I. Legal Framework Work Group Recommendations

A. Statement of Problem

The current first-tier excise taxes imposed by Internal Revenue Code section 4941 on disqualified persons and managers who engage in self-dealing transactions (5% and 2.5% of the amount of the transaction) may be too low to deter the prohibited actions effectively. At the same time, the Secretary's current discretion under section 4962 to abate penalties imposed on disqualified persons and managers whose participation was due to reasonable cause and not willful neglect does not extend to foundation managers and disqualified persons involved in self-dealing transactions, at times leading to harsh and unjust results. This is particularly true in cases where the violation has been inadvertent, the foundation was not harmed or the individuals involved received no "excess benefit" (and thus would not have been subject to an excise tax at all if the organization involved had been a public charity). One common example of this situation is where a well-meaning board member allows the foundation to rent space in a building she owns for less-than-market-value rent. In addition, penalty provisions are ineffective deterrents without effective enforcement.

B. Recommendations

The majority of the Work Group recommends (a) an increase in the rate of the first-tier excise tax imposed by section 4941(a)(1) on disqualified persons from 5% to 25%; and (b) an increase in the rate of the first-tier excise tax imposed by section 4941(a)(2) on organization managers who knowingly participate in self-dealing transactions from 2.5% to 10%, *provided that* the abatement of first-tier taxes provided in appropriate circumstances in the discretion of the Secretary under section 4962 is extended to include abatement of the taxes imposed by section 4941(a). The Work Group also recommends increased enforcement of the excise tax provisions.¹

¹ Note that the Governance and Fiduciary Responsibility Work Group has considered the related issue of the standard of knowledge for imposition of this and other excise taxes on organization managers in Issue #13, Standards for Imposition of Penalties on Organization Managers."

Note: These recommendations have not yet been reviewed by the Panel on the Nonprofit Sector. They will be part of the deliberations by the Panel as it prepares its interim report.

C. Rationale

The recommended increases in the first-tier excise taxes on disqualified persons and foundation managers may help deter self-dealing transactions. However, the increase in these first-tier excise taxes must be coupled with abatement of these taxes in appropriate circumstances, as an increase in the tax rates without an extension of the abatement provisions would only compound the inequity of the result in circumstances such as the below-market-rent situation noted above. Extension of abatement would also promote greater symmetry in the penalties imposed on disqualified persons and managers of private foundations (under section 4941) and of public charities (under section 4958), as penalties on charity managers and disqualified persons currently may be abated under section 4962. Finally, without effective enforcement, abusive transactions will not be deterred despite the increased penalties.

D. Other Considerations

Some Work Group members felt that increasing the first-tier excise tax rates on participation in self-dealing transactions to the same level as the rates imposed under section 4958 on participation in excess benefit transactions would not be equitable. It was noted that, in the case of a self-dealing transaction, the excise tax is imposed on the entire amount of the transaction, while in an excess benefit transaction, the excise tax is imposed only on the “excess benefit” received by a disqualified person. Thus, if the rates of tax were the same, then invariably the excise taxes imposed on foundation managers and disqualified persons would be higher than the excise taxes imposed on public charity managers and disqualified persons engaging in the same transactions. Therefore, it was suggested that either (a) the section 4941 excise tax on self-dealing be replaced with an excise tax on excess benefit transactions or (b) the first-tier excise tax rates for participation in self-dealing remain lower than the first-tier excise tax rates for participation in excess benefit transactions.

II. Expert Advisory Group Comments

The Expert Advisory Group recommends that, along with the Work Group’s recommendation of an expanded abatement provision, a recommendation be made that appropriate standards for abatement be determined. The Expert Advisory Group felt that such standards were necessary for consistent application of the abatement provision. In addition, the Expert Advisory Group recommends that the language of the abatement provision in IRC section 4962 be revised to more closely coordinate with the language of the penalty provisions in sections 4941 through 4945 and 4958.