

IRS Sanctions Intermediate Sanctions Muscle

Aug 01 2002

Practice Area: Tax

On May 22, 2002, the United States Tax Court issued its decision in *Carraci v. Commissioner of the Internal Revenue Service*. Carraci is one of the first reported decisions involving the IRS' use of the excess benefit excise tax provisions of Internal Revenue Code § 4958 (otherwise known as "intermediate sanctions") which took effect on September 14, 1995. Although the court did not fully adopt the IRS position, it still upheld penalties exceeding \$13 million assessed against the directors and officers of a 501(c)(3) corporation. Here's the story.

Stay-Home Health Agency was a 501(c)(3) corporation operating various home health agencies in Mississippi. Although exempt, Stay-Home was effectively controlled by the Carraci family: a husband and wife and their three adult children and spouses. On October 1, 1995, Stay-Home transferred all its assets and liabilities to for profit corporations owned by the family. Prior to this transaction Stay-Home had annual revenue of \$44 million, a book value of \$10.7 million and liabilities of \$12.1 million. The purchase price paid by the Carraci corporations was the assumption of the \$12 million of liabilities. After the transaction occurred, the Carracis obtained a third-party appraisal which concluded that the fair market value of the business was less than the liabilities.

The IRS caught wind of the transaction (probably through Form 990 reporting) and initiated an audit that resulted in the assessment of penalties exceeding \$42 million against each of five individuals and the for-profit corporations. An IRS appraiser had determined that the fair market value of the Stay-Home business was approximately \$30.5 million. Since the corporations only paid \$12 million (the liabilities assumed) the IRS concluded that an excess benefit of \$18.5 million had inured to the Carraci family and their corporations. The IRS "threw the book" at the Carracis. The assessment included \$4.6 million for the 25% first tier excise tax, \$37 million for the 200% second tier tax (for failure to correct the transaction) and \$30,000 for exempt organization manager taxes. These amounts were assessed in full against five of the Carraci family members because the intermediate sanctions penalties are joint and several. That is, any one of a group participating on an excess benefit transaction can be assessed the full amount of penalties.

In its decision, the Court rejected both the IRS and Carraci appraisals and, based on additional evidence presented during trial, found that Stay-Home had a value of \$18 million, so that the Carracis received an excess benefit of \$6 million. This left the Carracis responsible for a 25% first tier tax of \$1.5 million and a 200% second tier tax of \$12 million. The Court declined to revoke Stay-Home's exempt status (which is possible in addition to penalty taxes) so as to allow the Carraci family the opportunity to "correct" the transaction by returning funds to Stay-Home and thereby avoiding the 200% second tier tax.

The *Carraci* case was an extreme situation: exempt organizations don't often sell their entire business to for-profit corporations controlled by directors and officers. However, every exempt entity engages in insider transactions each year: when it compensates its executives. Exempt health care corporations also regularly enter into transactions with physicians, board members, or businesses they own. Although unusual, *Carraci* provides important lessons on how to minimize or avoid intermediate sanctions risk. Obtain solid information to support the fair market value of transactions with insiders, in advance, and rely on it. Make sure any appraisals obtained follow available IRS guidance on acceptable methods. If you don't already have one, create an intermediate sanctions policy and obtain board approval of any insider transactions as described below.

Intermediate sanctions can apply to any transactions with disqualified persons (insiders). Disqualified persons automatically include directors, officers, key executives (CEO, CFO, etc.) and any entities that are more than 35% controlled by these individuals. Any other individuals that have substantial influence over the organization, as determined under a list of facts and circumstances, are also disqualified persons. Although all physicians are not insiders, those in medical staff leadership positions or that are significant admiters, will likely be considered disqualified persons.

The best protection is to surface these transactions to the board of directors (or an appropriate committee) and follow the rebuttable presumption procedures provided for in the intermediate sanctions final regulations issued on January 23, 2002. Transactions with a disqualified person will be presumed to be at fair market value (no excess benefit) if three conditions are met. First, the transaction must be approved by a board (or appropriate committee) composed of individuals having no conflict of interest in the transaction. Second, the board or committee must have obtained and relied upon appropriate data showing that the financial terms are at fair market value, prior to approval. Finally, the board or committee minutes must adequately document who participated in the approval, who was excused due to conflicts, and what information was relied upon in approving the transaction.

Complying with these three requirements will switch the burden of proof to the IRS to demonstrate that the transaction was not at fair market value. The IRS audit instructions specifically direct its agents to review corporate minutes for insider transactions and include a detailed checklist of the information to be obtained and reviewed to detect whether excess benefit transactions have occurred. Some advance homework and solid documentation of transactions will go a long way to preventing a *Carraci* scenario.

von Briesen & Roper Legal Update is a periodic publication of von Briesen & Roper, s.c. It is intended for general information purposes for the community and highlights recent changes and developments in the legal area. This publication does not constitute legal advice, and the reader should consult legal counsel to determine how this information applies to any specific situation.