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ABSTRACT: This Article discusses Caracci v. Commissioner, in which the Tax Court imposed intermediate sanctions based on its finding that insiders caused three applicable tax-exempt organizations to sell assets to three for-profit entities owned and controlled by those same insiders. It explores the standards enumerated in Caracci, hypothesizes as to the pending appeal, and examines the guidance given by the decision’s clarification of the intermediate sanctions provisions of the Internal Revenue Code.

As the first judicial opinion to struggle with the “intermediate sanctions regime”1 introduced in 1996 by the Taxpayer Bill of Rights 2 (TBOR2),2 the Tax Court’s opin-

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ion in Caracci v. Commissioner provides an excellent platform to study how intermediate sanctions work when insiders, or “disqualified persons” in the parlance of intermediate sanctions, cause an “applicable tax-exempt organization” to sell assets to a for-profit entity owned and controlled by those same insiders. In this regard, the issues raised by Caracci include the proper standards to determine fair market value, the proper standards to revoke tax-exempt status after TBOR2, and the standards for imposition of the organization manager tax. The case also addresses the integrated nature of the intermediate sanctions excise taxes and correction provisions, and the question of when, and under what circumstances, it is proper to impose not only the intermediate sanctions excise taxes, but also income taxes on the same excess benefit amount.

As will be discussed, Caracci tells us that the post-TBOR2 revocation standards have changed dramatically, that the excise tax and correction rules are highly integrated and function pretty much as anticipated, with only some notable potential weak spots in the correction regulations, and that in many cases, income tax may be imposed in addition to excise taxes on the same excess benefit amount. Finally, Caracci illustrates the high costs associated with the combined economic effect of excise taxes, income taxes, and correcting an excess benefit transaction. In that regard, Caracci should serve as a reality check for entrepreneurs regarding the difficulties they will encounter if they attempt to operate what is intended to be a proprietary, for-profit enterprise using a nonprofit, tax-exempt entity.

I. The Caracci Case

A. The Sta-Home Health Entities, a Classic American Success Story—Until October of 1995

In many respects, the saga of the three Sta-Home Health entities (Tax-Exempt Entities) chronicled in the Caracci opinion is a very familiar American success story. Joyce and Victor Caracci founded the Sta-Home Health entities in 1976 to provide home health services for homebound patients in central Mississippi. At that time, it was commonly assumed that a for-profit entity could not perform such services in Mississippi. Consequently, the Caraccis organized the Sta-Home Health entities as nonprofit, Mississippi nonstock corporations, which the Internal Revenue Service (Service) recognized as tax-exempt under Section 501(c)(3) of the Internal Revenue Code (Code) and classified as public charities because they met the support tests under Section 509(a)(2) of the Code.
Like other entrepreneurs striving to get a new venture off to a successful start, Victor and Joyce Caracci borrowed money secured by their residence to fund the early operations of the Tax-Exempt Entities, and they individually guaranteed credit lines to fund working capital needs. In addition to putting their personal assets at risk, Mr. and Mrs. Caracci brought their children into the business. Their children and their children’s spouses made key contributions to management and operations of the Tax-Exempt Entities.

The Caracci family found creative ways to make a difficult business work. For example, they paid their employees six weeks in arrears, thus effectively creating a permanent, interest-free loan from the employees that could be used as working capital. In addition, they created intangible assets that reflected the depth of their knowledge of the home health business, such as publishing in-house manuals setting forth valuable policies and procedures on a variety of topics, including personnel, nursing, home health aid, physical therapy, and social work. Their combined efforts provided a quality service to their patient base, earned an excellent reputation among the elderly population in central Mississippi, and enabled the Tax-Exempt Entities to achieve a dominant market share in their service area.

As a result, the Tax-Exempt Entities were successful operations, and all employees of the Tax-Exempt Entities were well-paid compared to industry norms. The Caraccis, for example, provided for themselves what the Tax Court referred to as “executive-level” compensation. Additionally, the Tax Court referred to overall compensation for the employees as “generous,” with the total payroll for the Tax-Exempt Entities being at about 80.5% of operating expenses, compared to a common range in the industry for that period of between 70% and 75%. The result of all this risk and hard work was to build value, with the Tax Court finding that in October of 1995, the Tax-Exempt Entities had a combined gross fair market value of $18,675,000 and a combined net fair market value of $5,164,000.

B. The Worm Turns—Events in 1994 and 1995 Threaten to Turn Success into Economic Disaster

1. Potential Changes to Medicare Reimbursement Rules Cause Concern

From the Caracci family’s perspective, late 1994 began a series of events that threatened to turn this seeming classic American
success story into an economic disaster. During 1994 and 1995, over ninety-five percent of the Tax-Exempt Entities’ services were provided to Medicare beneficiaries. Medicare paid home healthcare agencies for the necessary services they provided to covered beneficiaries on a retrospective cost system under which Medicare sent a periodic interim payment every two weeks to home healthcare agencies to cover claims activity. The Tax-Exempt Entities used the periodic interim payments to fund their biweekly payroll. The Tax-Exempt Entities also submitted quarterly reports and filed annual cost reports with the fiscal intermediary.

If the periodic interim payments differed from the payments allowable as determined by the cost report, the fiscal intermediary made the appropriate adjustment by reimbursing the Tax-Exempt Entities for an underpayment or requiring the Tax-Exempt Entities to remit an overpayment. Under this cost-reimbursement system, the Tax-Exempt Entities could not realize profits beyond costs (although costs included generous compensation to the principals). In fact, because not all costs were fully reimbursed by Medicare, the Tax-Exempt Entities had, after payment of compensation, operating losses during the three years prior to 1995.

In 1994, it appeared that Medicare would shift from a periodic interim payment cost reimbursement system to a prospective payment system. While they were uncertain as to what form this prospective payment system would take, the Caracci family understood that under the new system, the Tax-Exempt Entities would not receive a check every two weeks but would have to file a claim for every service rendered and wait for the claim to be processed and paid. The Caraccis feared that the lack of a bi-monthly check would exacerbate existing cash flow problems, further reduce revenue, and create even larger losses in the future.

2. Proposed Solution—Sell the Assets of the Tax-Exempt Entities to Three New, Mirror-Image, For-Profit S Corporations Owned and Controlled by the Caracci Family

Concerned about the adverse impact of the proposed changes in the reimbursement system, in December of 1994 the Caracci family consulted an attorney named Thomas Kirkland (Kirkland) about the feasibility of converting the Tax-Exempt Entities into for-profit corporations. Kirkland’s firm represented many home health agencies, and he had recommended that all of those agencies make such a conversion. In part, Kirkland’s recommen-
dation was based on discussions with bankers who were reluctant to lend money to nonprofit home health agencies. For a variety of sound business reasons, the Caraccis’ regular accounting firm (Hart Firm) also recommended that the Tax-Exempt Entities convert to for-profit status.17

To assist with the conversion, Kirkland retained a tax attorney named James Pettis (Pettis). After learning that Kirkland’s firm had not obtained an appraisal for any of its previous conversions, Pettis advised the Caraccis to obtain a valuation before going forward. In response, the Caraccis authorized Pettis to retain the family’s regular accountants, the Hart Firm, to appraise the Tax-Exempt Entities’ net assets.18

After reviewing the Hart Firm’s appraisal, Pettis was concerned that the appraisal failed to deal with issues concerning intangible assets. According to Pettis, the fact that an entity had lost money or had a negative cash flow did not mean that the entity was worthless. In response, the Hart Firm produced a second appraisal that purported to address the intangible assets. Still not satisfied, Pettis refused to sign off without seeking and receiving assurances from the Hart Firm that the Tax-Exempt Entities’ liabilities far exceeded the value of their assets and that the value of any intangibles would not give the Tax-Exempt Entities a positive fair market value.19

3. Lack of Independent Representation for the Tax-Exempt Entities in the Conversion Process

As directors of both the buyers and the sellers and as shareholders of the buyers, the Caraccis obviously had a conflict of interest with respect to the proposed asset sale. In such a situation, “best practice” would be to obtain approval of the transaction on behalf of the Tax-Exempt Entities from disinterested representatives of the Tax-Exempt Entities who have appropriate authority to deal with the transaction.

Despite their obvious conflict of interest, the Caracci family made all of the decisions for both the S corporations and the Tax-Exempt Entities. There was no attempt by the Caraccis to follow a process that even remotely resembled the intermediate sanctions regime’s rebuttable presumption of reasonableness procedure.20

Because the Caraccis acted for both buyer and seller, the Tax-Exempt Entities had no separate, independent fiduciaries looking out for their best interests. Kirkland, Pettis, and the Hart Firm apparently functioned as advisors to the Caracci family or to “the
transaction” in general; therefore, the Tax-Exempt Entities also had no separate, independent professional representation. Although disinterested approval is clearly best practice and is encouraged under both the Code and Mississippi nonprofit corporation law, under both the tax rules and the Mississippi state law, disinterested approval is not required if the transaction is structured on fair market value terms and conditions and is fair to the Tax-Exempt Entities.21

4. Closing of the Asset Sales and the Effective Date of TBOR2

The asset sales were effective on October 1, 1995.22 Significantly, the closing date was almost ten months before Congress and the President finished their work on TBOR2. Although TBOR2 was signed into law on July 30, 1996, it was retroactively effective for transactions taking place on or after September 14, 1995, with an exception to this effective date for transactions covered by binding commitments in effect on September 14, 1995.23 Unfortunately for the Caraccis, the October 1, 1995, closing date was two weeks after TBOR2 became effective. Furthermore, because on September 14 the parties to the asset sales did not have binding commitments to close, the Caraccis were unable to take advantage of the transition rule in TBOR2. Consequently, the asset sales by the Tax-Exempt Entities to the newly formed S corporations were covered by the intermediate sanctions regime of TBOR2.

5. Post-Conversion Status of the S Corporations and the Tax-Exempt Entities

After the closing, the S corporations, like the Tax-Exempt Entities before them, provided home health services in Mississippi, used variations of the name “Sta-Home Health,” and were controlled and operated by members of the Caracci family. The Tax-Exempt Entities were not dissolved, and they still exist under Mississippi law,24 although they have no assets, have not engaged in any activities, charitable or otherwise, and are inactive shell corporations with few possibilities for reacquiring charitable assets and beginning new operations other than through unwinding the transactions. While it is clear that the Tax-Exempt Entities still exist and that they are still Section 501(c)(3) organizations, it is not as clear that they are still public charities under Section 509(a)(2) of the Code. Their inactivity would seem to make it impossible for them to pass the support tests necessary to avoid private foundation status.
6. Internal Revenue Service Position—Inadequate Consideration Paid and Excess Benefit Transaction Results

Because the Tax-Exempt Entities are nonprofit, tax-exempt Section 501(c)(3) entities, the $5,164,000 net fair market value that the Caraccis created belongs not to the Caracci family but to the Tax-Exempt Entities, and the federal tax laws will not let the Caraccis remove the value that their capital and their hard work created without paying full fair market value for the assets. Although the Caraccis believed, based on the Hart Firm’s valuation, that they had paid full fair market value and then some for the assets, the Service’s audit disagreed and contended that the $13,100,000 of liabilities was inadequate consideration for the assets of the Tax-Exempt Entities, making each transaction an “excess benefit transaction.”

Based on this contention, the Service sought four principal items of relief: (1) first-tier (25%) and second-tier (200%) excise taxes from Caracci family members and the S corporations as “disqualified persons;” (2) organization manager excise taxes (10% capped at $10,000 per transaction) from Caracci family members who were directors and officers of the Tax-Exempt Entities; (3) revocation of tax-exempt status of the Tax-Exempt Entities, each of which remained in existence as dormant, shell corporations after the asset sales; and (4) income tax from three Caracci family members because their S corporation shares became more valuable as a result of the bargain purchase of the assets of the Tax-Exempt Entities.

7. A Split Decision by the Tax Court

Before trial, the Service abandoned its claim for the organization manager taxes, giving the Caraccis a victory on that point. After hearing the case, the Tax Court sided with the Service on the inadequate consideration/fair market value question and found that the asset sales were excess benefit transactions. As a result, because the Caraccis had not corrected the excess benefit transactions as of the date of the decision, both the first-tier and second-tier intermediate sanction excise taxes were imposed on the disqualified persons involved. The Tax Court, however, refused to revoke the tax-exempt status of the Tax-Exempt Entities and found that, on the facts before it, the Service could not impose income tax liability or intermediate sanctions excise tax liability on the amount of the excess benefit received.
8. Appeals of the Tax Court’s Findings and Subsequent Events

At first, neither side appeared to be happy with this split decision by the Tax Court, and both the Service and the Caraccis appealed the Tax Court’s decision to the United States Court of Appeals for the Fifth Circuit. Since filing its initial notice, however, the Service has reconsidered and has withdrawn its appeal, leaving only the Caraccis' appeal of the valuation/excess benefit transaction issues for consideration by the Fifth Circuit. As will be discussed, the Tax Court’s approach to both the revocation issue and the income tax issue is questionable in some respects, so it will be interesting to see how both the Service and the courts address these important topics in the future as the law in this area continues to develop.

II. Overview of the Intermediate Sanctions Regime

A. Purpose of Intermediate Sanctions

Section 4958 governs transactions involving “applicable tax-exempt organizations,” generally defined as Section 501(c)(3) public charities and Section 501(c)(4) social welfare organizations. Before the enactment of Section 4958, if an applicable tax-exempt organization violated the private inurement rules, the Service’s only recourse was to revoke the organization’s exemption. The Treasury Department realized that such a response might be inappropriate when the exempt organization was still capable of functioning for a tax-exempt purpose; therefore, it urged Congress to provide for the Section 4958 excise taxes as an “intermediate sanction,” to be applied in lieu of, or in addition to, revocation.

B. Excess Benefit Transactions and Disqualified Persons

Section 4958 of the Code targets “excess benefit transactions” with “disqualified persons.” An excess benefit transaction is:

any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.
A disqualified person is: (1) “any person who was, at any time during the five-year period ending on the date of the transaction, in a position to exercise substantial influence over the affairs of the organization;” (2) a member of the family of a disqualified person; and (3) a 35% controlled entity, including a corporation in which the disqualified person directly or indirectly owns 35% or more of the combined voting power of the corporation.

C. Disqualified Persons—Taxes and Correction

In the event of an excess benefit transaction, the disqualified person is subject to a two-tiered excise tax. The disqualified person is first subject to a tax of 25% of the excess benefit, which is the difference between the value of the benefit provided to the disqualified person and any consideration rendered in exchange. If the disqualified person does not “correct” the transaction before the earlier of the time that the Service mails a statutory notice of deficiency with respect to the first-tier tax or assesses the first-tier tax, the disqualified person becomes subject to a second, additional excise tax equal to 200% of the excess benefit. In this context, correction means “undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than what it would have been in if the disqualified person were dealing under the highest fiduciary standards.” If more than one disqualified person is involved in an excess benefit transaction, the liability of the disqualified persons for the excise taxes imposed is joint and several.

D. Organization Managers—Taxes

In addition to the sanctions imposed on disqualified persons, “organization managers” potentially face a tax equal to 10% of the excess benefit, which is capped at $10,000 per transaction. Organization managers are subject to the tax if they participate in an excess benefit transaction “knowing” that it is an “excess benefit transaction,” unless the participation is not “willful” and is due to “reasonable cause.” As with the liability for the disqualified person tax, organization managers are jointly and severally liable for any organization manager taxes imposed in a transaction.

E. Disclosure of the Excess Benefit Transaction Required on Line 89b of Form 990

If a transaction is an excess benefit transaction, there is no excise tax imposed on the applicable tax-exempt organization itself.
The applicable tax-exempt organization is, however, required to disclose and to describe the transaction on Line 89b of its annual Form 990, Return of Organization Exempt from Tax. With respect to this disclosure requirement, it is important to remember that the Form 990 is a public document and that an applicable tax-exempt organization is required to provide a copy of its Form 990 to anyone who requests it. In addition, a nonprofit organization known as Guidestar collects the Forms 990 from the Service, images them, and makes them available on the Guidestar.org Web site.

F. Abatement

To encourage correction, the intermediate sanctions regime provides disqualified persons with an opportunity to have both the first-tier and the second-tier excise taxes abated. The second-tier tax will be automatically abated if the disqualified person corrects the transaction in a timely manner. Unlike the abatement of the second-tier tax, abatement of the first-tier tax is not automatic. Before abatement of the first-tier tax is granted: (1) there must be timely correction; and (2) the disqualified person must establish to the satisfaction of the Service that the disqualified person’s participation in the excess benefit transaction was due to reasonable cause and not due to willful neglect. In this context, reasonable cause means “ordinary business care and prudence,” and willful neglect means “a conscious, intentional failure or reckless indifference.”

G. Additional 100% Penalty for Repeated or Willful and Flagrant Violations

Although not part of TBOR2, Section 6684 of the Code functions as an integral part of the intermediate sanctions regime. Under Section 6684, if a person becomes liable for either the disqualified person taxes or the organization manager taxes imposed by Section 4958 of the Code by reason of any act or failure to act that: (1) is not due to reasonable cause; and (2) either (a) such person has been liable for such taxes before, or (b) the person’s act or failure to act is both willful and flagrant, then the person shall be liable for an additional penalty equal to the amount of the tax imposed under Section 4958 of the Code.

Again, reasonable cause should mean ordinary business care and prudence, and under the applicable Treasury Regulations, the disqualified person or organization manager has the burden to prove reasonable cause. The Service, however, has the burden to prove that the act or failure was both “willful” and “flagrant.”
In this context, a willful and flagrant act or failure to act is one that is both voluntarily, consciously, and knowingly committed in violation of any provision of Section 4958 of the Code and that would appear to a reasonable man to be a gross violation of any of the provisions of Section 4958 of the Code.

III. Organization Manager Tax

A. The Service’s Concession of the Organization Manager Tax in Caracci

The Service originally assessed the 10%, with a $10,000 per transaction cap, organization manager tax against Joyce Caracci, Michael Caracci, and Christina McQuillen, the three members of the Boards of Directors of the Tax-Exempt Entities. Prior to trial, however, the Service conceded that the organization manager tax did not apply to the Caraccis. Consequently, except to note the concession, the organization manager tax was not discussed in the Tax Court’s opinion. Nevertheless, because the Caraccis did not follow best practice and appoint independent fiduciaries to handle the transaction for the Tax-Exempt Entities, the Service’s concession on this point is important and instructive regarding the nature of the organization manager tax.

B. Computation of Organization Manager Tax

It should be noted that while the amount of the organization manager tax may be considered relatively nominal in a transaction of this size (10% of the excess benefit, capped at $10,000 per transaction), the Service applied the tax to each of the three sales, and the liability of the organization managers is joint and several. As a result, each of the organization managers was assessed $30,000 for the organization manager taxes. Thus, they were jointly and severally liable for $90,000, the total tax for all managers for all three transactions. Consequently, organization managers can expect that the Service will search aggressively to find more than one transaction when possible and will assess the tax separately for each such transaction. This approach, coupled with the joint and several nature of the tax, can ratchet up the exposure to the more-than-nominal level, and thus increase the deterrent effect of the tax.

C. Knowing Participation, Willful Participation, and Participation Without Reasonable Cause

It is clear that the Caraccis were the only fiduciaries acting on behalf of the Tax-Exempt Entities, and it is equally clear that
they had a conflict of interest. Furthermore, the Tax-Exempt Entities did not have access to independent professional advice. Nevertheless, despite the Caraccis’ failure to follow “best practice” and appoint independent fiduciaries to represent the Tax-Exempt Entities, the Service apparently did not feel the Caraccis’ conduct triggered the organization manager tax.

Under Section 4958(a)(2) of the Code, the organization manager tax will be imposed on an organization manager’s “knowing” participation in an excess benefit transaction, unless the organization manager’s participation is not “willful” and is “due to reasonable cause.” For these purposes, “knowing” connotes actual knowledge, not reason to know; “willful” denotes a conscious, intentional failure to comply with the law or a reckless indifference to the standards required by the law; and “reasonable cause” means exercising “ordinary business care and prudence” under the circumstances.

In Caracci, the record indicates that the Caraccis consulted with lawyers and tax advisors (Kirkland and Pettis) and with accountants and valuation consultants (the Hart Firm) at each step in the process of planning and implementing the conversion transactions. The record also indicates that the Hart Firm (which, given its relationship with the Caracci family, and its role in the transaction, was not independent) produced a valuation of the Tax-Exempt Entities that showed that each had a negative net worth and that the aggregate liabilities assumed by the S corporations exceeded the aggregate fair market value of the Tax-Exempt Entities. These factors apparently were enough to negate the knowing nature of the Caraccis’ participation. In addition, the reliance on the Hart Firm appraisal, which showed that the amount of the liabilities assumed exceeded the value of the assets transferred, also apparently negated willfulness, and the Caraccis’ consultation with lawyers, tax advisors, and accountants/valuation advisors at each step apparently established ordinary business care and prudence.

D. Impact of the Final Regulations

It is unlikely that the result in Caracci would have been different if the court had considered the issue and applied the Final Regulations.

1. Knowing Participation

Under the Final Regulations, an organization manager’s participation is “knowing” only if the person:
(A) Has actual knowledge of sufficient facts so that, based solely upon those facts, such transaction would be an excess benefit transaction;

(B) Is aware that such a transaction under these circumstances may violate the provisions of Federal tax law governing excess benefit transactions; and

(C) Negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the manager is in fact aware that it is such a transaction.62

Furthermore, under the Final Regulations, the Service has the burden of proof to establish whether an organization manager has knowingly participated in an excess benefit transaction.63

Under the Final Regulations, an organization manager’s participation in a transaction is ordinarily not considered knowing, even though the transaction is subsequently held to be an excess benefit transaction, to the extent that, after full disclosure of the factual situation to an appropriate professional, the organization manager relies on a reasoned, written opinion of that professional with respect to elements of the transaction within the professional’s expertise. For these purposes, “a written opinion is reasoned even though it reaches a conclusion that is subsequently determined to be incorrect so long as the opinion addresses itself to the facts and the applicable standards.”64 In addition, “[a]n organization manager’s participation in a transaction is ordinarily not considered knowing . . . even though the transaction is subsequently held to be an excess benefit transaction, if the appropriate authorized body has met the requirements” to trigger the rebuttable presumption of reasonableness.65

2. Willful Participation
The Treasury Regulations also provide that:

participation by an organization manager is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. However, participation by an organization manager is not willful if the manager does not know that the transaction in which the manager is participating is an excess benefit transaction.66
3. Reasonable Cause

“An organization manager’s participation is due to reasonable cause if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence.”

4. Probable Result Under the Final Regulations

Again, the Caraccis did not follow any process even remotely resembling the rebuttable presumption process, so they would not have been able to rely on that safe harbor in the regulations. In addition, under the Final Regulations, for valuation matters, an organization manager can only rely on independent valuation experts who: “(1) Hold themselves out to the public as appraisers or compensation consultants; (2) Perform the relevant valuations on a regular basis; (3) Are qualified to make valuations of the type of property or services involved; and (4) Include in the written opinion a certification” that the foregoing three requirements are met. It is not likely that the Hart Firm would meet these criteria for valuation of home health agencies.

On the other hand, it is still probable that the Caraccis would have escaped the organization manager tax. The Service might have argued that the process employed by the Caraccis did not reflect a high level of sophistication and that the Hart Firm did not pass muster for a valuation expert with respect to home health agencies. Nevertheless, it is not necessary to trigger the rebuttable presumption to avoid “knowing participation,” nor is it necessary to rely on the reasoned opinion of value of a valuation expert. These are only safe harbors to negate the knowing nature of a manager’s participation, not requirements for avoiding the tax.

Thus, even given the process employed by the Caraccis and the suspect nature of the Hart Firm’s credentials, it is unlikely that the Service could show that the Caraccis had “actual knowledge” that the Hart Firm appraisal undervalued the assets or, given the consultation with Kirkland and Pettis, that they were willful or did not exercise reasonable business care and prudence in planning and closing the transaction. As a result, the Service’s concession in Caracci indicates that if an organization manager pays attention to, and follows the guidance set forth in the Final Regulations, including obtaining a reasoned opinion of valuation experts and legal or tax counsel and attempting in good faith to trigger the rebuttable presumption, the organization manager can have a high degree of comfort that the organization manager excise tax will not be imposed.
IV. Valuation Matters

A. Solid Valuation is the Lynchpin To Success

An excess benefit transaction is any transaction in which an economic benefit provided by a tax-exempt entity to any disqualified person exceeds the value of the consideration received in exchange. As a result, the linchpin of any determination under Code Section 4958 is valuation. If the transaction is not structured on fair market value terms and conditions, an excess benefit transaction will result. Thus, any transfer of property from an applicable tax-exempt entity to a disqualified person, particularly the transfer of the entire business of the applicable tax-exempt entity, must include a valuation of the transferred assets that will withstand close scrutiny.

Because of the key role valuation plays in any transfer of property from an applicable tax-exempt organization to a disqualified person, much of the Caracci opinion deals with the intricacies of valuation of the assets of the Tax-Exempt Entities purchased by the S corporations. In this regard, the Tax Court’s discussion of valuation in Caracci illustrates several very important points about the nature of the definition of fair market value, the need for careful and contemporaneous determinations of fair market value, and the uphill battle the parties face if they cannot convince the trier of fact that their position on fair market value is correct.

B. Fair Market Value Contemplates a Hypothetical Buyer and Seller, Not the Actual Parties to the Transaction

In the case of a transfer of property, Section 4958 of the Code employs the traditional definition of fair market value for property. Under this standard, fair market value is the price that a willing buyer would pay a willing seller, with both persons having reasonable knowledge of all relevant facts and neither person being under any compulsion to buy or to sell. The determination of fair market value is a factual determination, not a legal conclusion. Furthermore, the willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities, and the characteristics of these hypothetical persons are not necessarily the same as the personal characteristics of the actual seller or a particular buyer. Fair market value reflects the highest and best use of the relevant property on the valuation date, taking into account special uses that are realistically available to a hypothetical buyer because of the property’s adaptability to a particular business. In this regard, fair market value is not affected by whether the owner has actually put the property to its
highest and best use; hence, the hypothetical willing buyer and seller are presumed to be dedicated to achieving the maximum economic advantage.\(^{70}\)

At the time of sale, the Caracci family’s commonsense approach to valuing the assets of the Tax-Exempt Entities was that, in their hands, the Tax-Exempt Entities could never turn a profit because the Medicare cost reimbursement formula only reimbursed costs and prohibited turning a profit. Further, because some portion of the actual costs was always not reimbursable for one reason or another, the Medicare reimbursement system guaranteed that the Tax-Exempt Entities would always operate at a loss. Because the Tax-Exempt Entities could only operate at a loss, they therefore could never have a positive fair market value.

As noted, however, under the legal standards applied by the Tax Court, fair market value does not focus on the value of the property in the hands of the actual buyer of the property. Rather, the focus is on the value of the property in the hands of a hypothetical buyer who has available all relevant information, who takes into account special uses that are realistically available, and who is dedicated to putting the property to its highest and best use, coupled with a hypothetical seller who also has all of the foregoing attributes and who is dedicated to achieving the maximum economic advantage from the property being sold.

At the time the transaction closed, the evidence in the record indicated that there were buyers in the market for home health agencies, such as hospitals and nursing homes, that could take advantage of an intangible asset held by the Tax-Exempt Entities. This was the so-called cost gap that permitted hospitals and nursing homes to benefit by acquiring a home healthcare agency and shifting some of their overhead costs to that agency in a manner that the Caraccis could not. Thus, although the Caraccis’ failure to deal adequately with the cost gap issue at the outset was not the sole reason the Tax Court concluded they had significantly undervalued the assets involved, the Caraccis’ sole focus on the value of the Tax-Exempt Entities in their hands, rather than in the hands of a hypothetical buyer and seller, was a substantial contributing factor to their undervaluation of the assets of the Tax-Exempt Entities.

**C. Qualified, Independent Appraisers a Must**

In addition, the problems the Caraccis encountered in the Tax Court illustrate the importance of engaging professional consultants who have the necessary expertise and experience to do
the job correctly in the first instance. The record indicates that the Caraccis first consulted the Kirkland law firm, which, whatever its expertise in advising on the day-to-day operations of home healthcare agencies, had followed a practice of not obtaining crucial appraisals in similar transactions. This is clearly not best practice for this kind of transaction. To its credit, however, the Kirkland firm brought in Pettis, the tax attorney, to advise the Caraccis regarding tax compliance for the transaction. Pettis recognized the risks of proceeding without a valuation, and he advised the Caraccis to obtain an appraisal of the assets involved.

Acting on this advice from Pettis, the Caraccis turned to the Hart Firm, their regular accountants. The Hart Firm apparently enjoyed an excellent reputation as an accounting firm that could deal with the day-to-day operations of enterprises like the Tax-Exempt Entities. From the Hart Firm’s approach to valuing the assets, however, it is a fair inference that it had no particular credentials as an appraiser of home health agencies. The validity of this inference is suggested by the fact that, among other things, the Hart Firm apparently focused on the value of the assets in the hands of the Caraccis, not on a hypothetical buyer and seller. Additionally, it failed to normalize earnings to take into account the impact of higher than normal bonuses paid to the Caraccis, ignored in its first appraisal effort (and failed to take into account appropriately in its second and final appraisal effort) substantial intangible assets, and did not conform its valuation analysis to published revenue rulings governing valuation.

D. Competent, Contemporaneous Documentation Crucial

The Caracci opinion also highlights the importance of having the proper due diligence done and documented contemporaneously with the planning and closing of the transaction. Just as importantly, the opinion points out the difficulties that will be encountered in trying to bail out deficient up-front due diligence with after-the-fact rationalizations, however creative and well-developed.

In the Tax Court proceedings, the Caraccis employed the services of Alfred D. Hahn, a director in PricewaterhouseCoopers Northeast Region Corporation Valuation Consulting Group. Hahn had extensive experience in valuing home healthcare agencies and had written extensively on the subject. Despite Hahn’s impressive credentials and his considerable and creative effort, the Tax Court rejected Hahn’s attempt to support and justify the work initially done by the Hart Firm, stating:
We are unimpressed and unpersuaded by Hahn’s conclusions as to the fair market value of the StaHome tax-exempt entities, and we have decided not to accept them. His reasoning that the StaHome tax-exempt entities had a fair market value of less than zero is unconvincing, and, in fact, appears to be more an advocacy of petitioners’ litigating position than a candid fair market appraisal. We think a willing buyer would be puzzled and confused by his conclusions.72

E. Factual Nature of Fair Market Value and Clearly Erroneous Standard on Appeal

As discussed, the determination of fair market value is a factual determination, and the trier of fact must weigh all relevant evidence of value and draw appropriate inferences from the facts in the record to arrive at a determination of fair market value.73 Here, the Tax Court did just that. The court received and considered the testimony of experts for both the Caraccis and the Service, and independently reviewed the record as a whole and drew its own conclusions as to certain matters. As a result, the opinion, in a balanced and nuanced manner, mixed and matched points the court considered relevant in the testimony of the experts for both sides with its own inferences and observations from the record as a whole.

The court then used these combined sources to arrive at its own findings of fact regarding fair market value. Therefore, because the standard of review on appeal for factual determinations made by the trier of fact is a “clearly erroneous” standard,74 the Caraccis would seem to have a difficult task ahead. They will have to demonstrate to the Fifth Circuit that the Tax Court’s determination of fair market value was so clearly erroneous as to erase the $5,164,000 margin of error (the amount of the excess benefit). The Caraccis also must convince the Fifth Circuit that the assets were worth less than the consideration paid and that, therefore, the conversion was not an excess benefit transaction. Alternatively, the Caraccis would have to convince the Fifth Circuit that the Tax Court erred in applying the hypothetical buyer-seller legal standard as it did, which, although interesting things sometimes occur when motivated lawyers make creative arguments, is likely also an uphill struggle.
V. Imposition of Both First-Tier and Second-Tier Excise Taxes

Having concluded that the value of the assets transferred to the S corporations was in excess of the consideration received for that transfer, the court imposed both the first-tier and second-tier excise taxes jointly and severally on the disqualified persons involved. Although they had not corrected the transaction, a necessary precondition to abatement, the Caraccis apparently requested that the court abate the excise taxes imposed under Code Section 4961 (second-tier abatement) and Code Section 4962 (first-tier abatement).

The court declined to do so, indicating that abatement was “at best, premature. [Because] Petitioners have not as of yet met the prerequisite for the requested abatement; i.e., a timely correction.” The court went on, however, to note that Sections 4961(a) and 4963(e)(1) of the Code generally allow for the abatement of the excess benefit excise taxes “if the excess benefit transaction giving rise thereto is corrected within 90 days after our decision sustaining the tax becomes final.” As will be discussed below, the court’s concern over the ability of the Caraccis to effect correction, a necessary precondition to abatement, appears to be a key component of the court’s analysis of the revocation issue.

VI. Revocation of Tax-Exempt Status

A. The Service’s Case for Revocation

In the statutory notices of deficiency, the Service asserted that the Tax-Exempt Entities’ transfer of their net assets to the S corporations for less than adequate consideration was a substantial activity not in furtherance of an exempt purpose, violating the operational test of the Treasury Regulations. The Service also asserted that these transfers indirectly enriched each of the Caraccis by increasing the value of their stock in each of the S corporations. As a result, the Tax-Exempt Entities conferred private inurement on each of the Caraccis, in violation of the proscriptions against private inurement and impermissible private benefit. Furthermore, by impermissibly benefiting private interests, the Service contended that the Tax-Exempt Entities no longer promoted health in a charitable manner by benefiting the community. For these reasons, the Service attempted to revoke the Code Section 501(c)(3) exemption of each of the three organizations.
On the facts before the court, the Service had what appeared to be a fairly strong case for revocation. In addition, after the transaction closed, the Tax-Exempt Entities were dormant, shell corporations with no assets or activities. In this regard, the House Report that accompanied TBOR2 made the following observation: “In practice, revocation of tax-exempt status, with or without imposition of excise taxes, would occur only when the organization no longer operates as a charitable organization.” At the time of the decision in Caracci, the Tax-Exempt Entities had sat idle for approximately seven and one-half years after the conversion and had carried on no charitable healthcare activities during that time. Thus, the Service argued that the legislative history suggests that the fact pattern presented by the Caracci case justifies revocation of the Section 501(c)(3) status of the Tax-Exempt Entities.

B. The Tax Court Refuses To Revoke Tax-Exempt Status

Had Caracci reached the Tax Court prior to the adoption of TBOR2’s intermediate sanctions regime, there was solid precedent for revocation of tax-exempt status in such a situation, in which insiders who are directors of a tax-exempt entity cause that entity to sell its assets to for-profit organizations owned and controlled by the directors. The court stated, however, that with the advent of intermediate sanctions, these circumstances no longer automatically resulted in revocation of exempt status. The court then concluded that the TBOR2 legislative history indicates that “both a revocation and the imposition of intermediate sanctions will be an unusual case,” which the court refused to find on these facts.

1. Dormancy Precludes Judicial Inquiry into Whether the Sta-Home Health Entities “On the Whole” Functioned as Tax-Exempt Entities

The court began its analysis of why revocation is not appropriate by quoting from the first sentence of footnote 15 to the TBOR2 House Report, which states that revocation is not appropriate when the “excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a . . . tax-exempt organization.” This “on-the-whole” standard is the proper standard for the post-TBOR2 analysis of whether revocation is appropriate.

While the court started at the right place, it then appears to have incorrectly read the first sentence of footnote 15 to require some level of activity, some “functioning,” by the applicable tax-
exempt organization, in order for the court to inquire into whether the organization was, “on the whole,” functioning as a tax-exempt entity.84 Because the Sta-Home Tax-Exempt Entities had been dormant for seven and one-half years at the date of the decision, there was no activity, no “functioning,” at all, so the court held that it was “precluded” from applying the “functioning on the whole as a tax-exempt entity” standard to the case before it.85

2. The Tax Court’s Three Factors in Favor of Preserving Tax-Exempt Status

Having made this questionable finding that the “functioning on the whole” standard was inapplicable, the court proffered three reasons why it felt revocation was not proper. First, the court stated that “we do not believe it appropriate under the facts herein to conclude that the single transaction (as to each entity) underlying the excess value also requires our revocation of each entity’s tax-exempt status.”86 Second, the court observed that “the Sta-Home tax-exempt entities have not since the transfers been operated contrary to their tax-exempt purpose.”87 Third, the court indicated that correction is an important goal of the intermediate sanctions regime and that “a permissible correction may require that the Sta-Home for-profit entities transfer the assets back to the Sta-Home tax-exempt entities. If we were to remove the Sta-Home tax-exempt entities’ tax-exempt status at this stage . . . those entities would no longer be tax-exempt entities available to receive the assets.”88

C. Analysis of the Court’s Approach To Revocation

Portions of the Tax Court’s analysis are consistent with the Code and the legislative history, and portions of the analysis are puzzling and hard to follow. As an initial matter, the court noted, correctly, that the pre-TBOR2 approach has changed. After TBOR2, a finding that a transaction results in traditional private inurement is a necessary first step to determine whether revocation is appropriate, but it is not the end of the inquiry. Something more must be involved, and the question is what additional factors must exist to revoke tax-exempt status. In this latter regard, the court’s analysis is, for the most part, confusing and not at all helpful.

1. Tax Court’s Refusal to Apply the “On the Whole” Standard Is Incorrect

As discussed, relying on the first sentence in footnote 15 to the House Report, the court noted the dormant nature of the Tax-Exempt Entities, and concluded that this lack of activity by the Tax-Exempt Entities “precluded” any inquiry into whether or not
they were functioning, on the whole, as tax-exempt entities. The court apparently read the first sentence of footnote 15 to require some level of activity in order to be relevant. That is, for this sentence to apply, there must be a series of affirmative activities being carried on by the tax-exempt entities that can be analyzed to determine if they are, on the whole, consistent with tax-exempt status. If there are no activities, the standard is not relevant, and some analysis other than the functioning on the whole analysis is required. This reading of the first sentence to footnote 15 is not justified and distorts the proper analysis of the circumstances in which revocation is appropriate.

2. A Single Transaction Can, in the Proper Circumstances, Justify Revocation

The first of the court’s three reasons for continuing tax-exempt status was that the single transaction that spawned the excess value did not require revocation of the entities’ tax-exempt status.89 This single act theory clearly would seem correct if the Tax-Exempt Entities were ongoing, functioning entities. In this context, the proper inquiry would seem to be whether the single act was aberrational and unlikely to recur or whether it was part of an ongoing pattern of activity suggesting that, on the whole, the entity has ceased to function as a tax-exempt entity. If the single act is aberrational and unlikely to recur, revocation would not be appropriate, and the remedy should be imposition of the excise taxes and/or correction of the transaction.90 Conversely, if the single act is part of a pattern, revocation should be the result.91

The basic point here is that the first sentence of footnote 15 should not be read to require some level of continuing activity to be relevant. Rather, it should be read to direct the courts to look into whether the entity is engaging in sufficient activities, which can range from no activities at all to a wide variety of substantial activities, so that the entity can be said to be functioning, on the whole, as a tax-exempt entity. If a single excess benefit transaction, to paraphrase the first sentence of footnote 15, “rises to the level” that there are no activities at all, and that there is a permanent dormant condition, then it is difficult to see how, on the whole, the entity can be said to be functioning as a tax-exempt entity.

Footnote 15 consists of two sentences, and this reading of the first sentence is consistent with the second sentence of the footnote. The second sentence, which the Tax Court did not cite
or discuss in its analysis, states: “In practice, revocation of tax-exempt status, with or without the imposition of excise taxes, would occur only when the organization no longer operates as a charitable organization.” Based on this language, it can be argued that the dormancy of the Tax-Exempt Entities is exactly the kind of circumstance contemplated by the legislative history as justifying revocation. That is, if a single transaction completely strips an applicable tax-exempt organization of its ability to function as a tax-exempt entity, it no longer operates as a charitable organization (and, on the whole, has ceased to function as a tax-exempt entity). Thus, absent some other substantial countervailing circumstances favoring preservation of status, revocation is proper, regardless of whether excise taxes are also imposed.

3. No Post-Transaction Activities Inconsistent with Tax-Exempt Status

The court’s second reason for not revoking tax-exempt status was that, after the date of the excess benefit transaction, the Tax-Exempt Entities had not been operated contrary to their tax-exempt purposes. In the context of an ongoing, active organization that continues to function after the excess benefit transaction, inquiring as to the post-transaction conduct of the organization is appropriate. It helps to determine whether the excess benefit transaction was, “on the whole,” aberrational and unlikely to recur or be part of a pattern of activity contrary to tax-exempt status. In the context of a single transaction that renders the exempt organization completely without resources or activities, however, the court’s second reason for denying revocation is a non sequitur. The court not only refused to treat as a negative the fact that the Tax-Exempt Entities were doing nothing at all to further their exempt purposes, but it also held that this same inactivity suggests tax-exempt status should be continued because, as the entities have done nothing, they have necessarily not taken any affirmative acts contrary to their tax-exempt status. This is a “heads the Caraccis win, tails the Service loses” approach.

4. Preservation of Tax-Exempt Status May Be Necessary to Effect Correction

The court’s third reason for not revoking tax-exempt status, to facilitate correction, is the only prong of the three-point analysis that, in the context of an organization that has been stripped of all its assets and exempt functions, seems consistent with the purposes of the intermediate sanctions regime. To encourage correction, the intermediate sanctions regime provides disqualified persons with an opportunity to have both the first-tier
and the second-tier excise taxes abated. The second-tier tax will be automatically abated if the disqualified person corrects the transaction in a timely manner. The first-tier tax will be abated: (1) if there is timely correction; and (2) if the disqualified person establishes to the satisfaction of the Service that the disqualified person’s receipt of the excess benefit was due to reasonable cause and not due to willful neglect.

Under the relevant legal authorities, reasonable cause means “ordinary business care and prudence,” and willful neglect means “a conscious, intentional failure or reckless indifference.” These standards are very similar to the standards used to judge whether the organization manager tax is imposed, and the Service conceded that the organization manager tax should not be applied to the Caraccis. It would seem, therefore, that the Caraccis would have an excellent opportunity to have the penalties abated, assuming correction can be effectuated.

The usual approach to correction contemplates a cash payment to the applicable tax-exempt entity in an amount equal to the correction amount (the excess benefit plus interest). Here, however, any way one examines it, correcting the excess benefit transaction with a cash payment will be an expensive proposition for the Caraccis. At the date of trial, the correction amount (the excess benefit amount, plus accumulated interest compounded for seven and one-half years at the applicable federal rate) was in excess of $8,000,000. The correction amount, of course, continues to rise as the litigation goes on and the interest accrues.

Thus, to correct with cash, the Caraccis will probably have to come up with an amount substantially in excess of the correction amount at the date of trial. It is probable that their only practical source of repayment is their interest in the S corporations, which at least at the time of the initial transaction had a net fair market value of $5,164,000. It is not clear, however, that the Caraccis could raise that much cash based on the collateral of the S corporations, and if they could raise that amount, it might be that adding such a substantial amount of leverage to the S corporations would require them to reduce the scope and nature of their services.

The Sta-Home Tax-Exempt Entities ranked first or second in market share in fourteen of the nineteen counties in their service area, “Sta-Home” was a recognized name in home healthcare in Mississippi, and it had a generally good reputa-
tion among Mississippi’s elderly population. Furthermore, the Tax-Exempt Entities were the first freestanding agencies in Mississippi to become accredited by the Joint Commission on Accreditation of Healthcare Organizations, by achieving or exceeding certain regulatory standards, including conditions as to the quality of patient care.\(^98\) Thus, the Sta-Home entities are major players in the home health market in central Mississippi, and are apparently quality home health agency operations.

As a result, in wanting to facilitate a non-cash correction, the court may have been concerned that requiring the Caraccis to correct through a large cash payment would drive the Sta-Home Health enterprises out of business or cause a significant downsizing of activities, either of which could harm the elderly population in their service area. Allowing the Caraccis to return the home health business to the Tax-Exempt Entities might be a way to prevent a dramatic disruption in home health service in this economically disadvantaged area.\(^99\) Such a non-cash payment approach to correction may indeed protect the charitable class served by the Tax-Exempt Entities: home health patients, ninety-five percent of whom were on Medicare.

**D. Proper Standard for Revocation Under the Intermediate Sanctions Regime**

While the Tax Court misread the first sentence to footnote 15 of the Legislative History and ignored the second sentence, footnote 15 does set forth the proper standard to determine when revocation is appropriate after TBOR2. Does the excess benefit transaction “rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization”?\(^100\) Has the excess benefit transaction, by itself, or in combination with other factors, created a set of circumstances in which “the organization no longer operates as a charitable organization”?\(^101\) When the organization continues to function after the excess benefit transaction, that analysis should look at all of the facts and circumstances before and after the transaction to determine whether the excess benefit was aberrational and unlikely to recur. If this analysis shows that the transaction was aberrational, intermediate sanctions, subject to abatement if correction is made, should be the sole remedy. If the analysis shows that the excess benefit was not aberrational, then revocation should occur. In this regard, the kinds of circumstances that should justify revocation should be the kinds of circumstances that would justify the imposition of the one-hundred percent penalty under Section 6684 of the Code. That is,
the parties must be shown to have not proceeded with ordinary business care and prudence with respect to the transaction or transactions in question and, in addition, the parties must have either been involved in repeated violations of the laws regarding private inurement, private benefit, and excess benefit, or have proceeded in a manner that indicates a willful and flagrant disregard for the rules governing the conduct of tax-exempt entities. Finally, if, as was the case in Caracci, a single transaction, standing alone, causes the organization to cease to function entirely as a tax-exempt entity, revocation ought to follow absent some strong countervailing factor, such as the Tax Court’s conclusion that revocation was not appropriate because preserving tax-exempt status might facilitate the correction process and, thereby, benefit the charitable class served by the organization.

VII. Correction in the Caracci Case Should Be Governed by the Final Regulations

The court stated in a footnote that none of the three sets of Treasury Regulations promulgated under Section 4958 of the Code applied in this case. This is correct as to the excess benefit transaction itself, which took place on October 1, 1995, prior to the effective date of any version of the regulations. Correction, however, is a separate event from the excess benefit transaction itself, and if the Caraccis ever correct, that correction will take place after the January 23, 2002, effective date of the Final Regulations.

This raises the question of whether the Final Regulations should govern the correction process in Caracci. Although described in Section 4958(f)(6) of the Code, correction for the Caraccis is the first step in the abatement process governed by Code Sections 4961 (second-tier abatement), 4962 (first-tier abatement), and 4963 (definitions). As a result, because correction is properly viewed as a part of the abatement provisions, rather than the provisions for identifying and penalizing excess benefit transactions in Code Section 4958, the fact that the new Treasury Regulations did not govern the October 1995 excess benefit transactions should not dictate the treatment of any future correction.

The abatement rules incorporate by reference the correction provisions of the Final Regulations. Section 4963(d) of the Code states that for purposes of abatement under either Code Sections 4961 (second-tier abatement) or 4962 (first-tier abatement), “correction” has the same meaning as when used in the
section of the Code imposing the second-tier tax for the type of excise tax in question. As to an excess benefit transaction under Code Section 4958, “correction” has the meaning set forth in Code Section 4958(f)(6). The abatement rules, therefore, ought to incorporate whatever rules are in effect under Section 4958(f)(6) of the Code and the applicable Treasury Regulations at the time of correction. In this case, this means that the standards set forth in Treasury Regulation Section 53.4958-7 should govern correction of the Caraccis’ excess benefit transactions.

A. Mechanics of Correction under the Final Regulations

Under the Final Regulations, disqualified persons have three options for correction. First, they can pay the applicable tax-exempt organization the “correction amount,” which is generally the amount of the excess benefit plus interest, in cash. Second, they can return “specific property” to the applicable tax-exempt organization, if the organization agrees to accept the property. Third, if the applicable tax-exempt organization no longer exists, or is no longer a tax-exempt organization, they can pay the correction amount to a Section 509(a)(1) public charity that has been in existence for a continuous period of at least sixty months and with which the disqualified persons do not have a disqualifying relationship. Each of these alternatives is discussed below.

1. General Rule for Correction (Cash Only)

The general rule is that a disqualified person corrects an excess benefit “only by making a payment in cash or cash equivalents, excluding payment by a promissory note, to the applicable tax-exempt organization equal to the correction amount.” To prevent abuse, a disqualified person may not correct under the general cash repayment rule if the Service “determines that the disqualified person engaged in one or more transactions with the applicable tax-exempt organization to circumvent the requirements” of the cash-payment alternative, with the result that “the disqualified person effectively transferred property other than cash or cash equivalents.”

2. Special Correction Rule One: Return of Specific Property

A special correction rule potentially allows the Caraccis to correct by unwinding the excess benefit transaction and returning the specific assets of the Tax-Exempt Entities that were improperly transferred. This alternative is the Final Regulations’ version of the correction method seemingly favored by the
Tax Court in its third reason for preserving the tax-exempt status of the Tax-Exempt Entities. In order to correct by returning “specific property,” the Caraccis would have to comply with three conditions.

First, the Tax-Exempt Entities would have to agree to accept the specific property. In this regard, it should be noted that the Tax-Exempt Entities cannot demand the return of the specific property. As a result, whether property will be returned is a matter of negotiation and agreement between the disqualified persons and the applicable tax-exempt organization. If it is advantageous to the organization to seek return of the property, the consensual nature of this alternative will give the disqualified person leverage in the transaction that the other alternatives do not provide.

Second, the disqualified persons would be treated as making a payment equal to the lesser of “(A) the fair market value of the property determined on the date the property is returned to the organization; or (B) the fair market value of the property on the date the excess benefit transaction occurred.” Accordingly, there would have to be a valuation of the Tax-Exempt Entities’ assets as of the date of the return of the assets, and that valuation would have to conform with the stringent standards the court established in the valuation portion of its opinion, including the hypothetical buyer and seller construct inherent in the tax law definition of fair market value. Furthermore, if the returned assets have a fair market value less than the correction amount, which means that the assets have decreased in value since the excess benefit transaction, the Caraccis must make an additional cash payment to make up the difference.

Third, no disqualified person who received an excess benefit may participate in the applicable tax-exempt organization’s decision of whether to accept the return of specific property. Here, none of the Caracci family could participate in the decision of whether to accept the return of the assets or the conditions that might attach to that return. Thus, unlike the initial sale transaction, the Caraccis will be forced to follow “best practice” and appoint or arrange for independent fiduciaries to represent the Tax-Exempt Entities in negotiating the return of the assets.

3. Special Correction Rule Two: The Applicable Tax-Exempt Organization No Longer Exists or is No Longer Tax-Exempt

A second special correction rule provides that, if the applicable tax-exempt organization no longer exists or is no longer tax-
exempt, disqualified persons may correct by paying the correction amount to a Code Section 509(a)(1) public charity (the Receiving Organization).118 As with correction by returning specific property, there are three conditions: (1) the Receiving Organization must have been in existence as a Section 509(a)(1) public charity for a continuous period of at least sixty calendar months ending on the correction date; (2) the disqualified person must not also be a disqualified person with respect to the Receiving Organization; and (3) the Receiving Organization must not allow the disqualified person (or a person related to the disqualified person) to make or recommend any grants or distributions by the Receiving Organization.119 This is the alternative the Caraccis would have been forced to follow if the Tax Court had revoked Section 501(c)(3) status of the Tax-Exempt Entities.

B. Application of Final Regulation Correction Alternatives to the Caraccis

Even without excise taxes, correction poses a substantial financial burden on the disqualified persons in Caracci. Assuming a more-than-eight-year correction period at an Applicable Federal Rate of 6.31% compounded annually, the correction amount will be substantially in excess of $8,000,000 by the time the Caraccis are forced to correct or pay the excise taxes.120 By comparison, if the transaction is not corrected, the disqualified persons would owe $11,619,000 in combined first-tier and second-tier excise taxes. Both the excise tax amount and the correction amount will be substantial compared to the combined resources of the S corporations and the Caracci family.

Given the relatively comparable financial burden between correcting with cash and not correcting at all in these circumstances, the disqualified persons in Caracci (and similarly situated persons in the future) may push hard to correct by returning the assets to the applicable tax-exempt organization involved, assuming the applicable tax-exempt organization is there to receive the assets. Assuming that the appropriate specific property could even be identified after a long period of operation subsequent to the excess benefit transaction, there would have to be a valuation of the specific property to establish whether there has been an increase or decrease in value since the date of the excess benefit transaction. If there has been a sufficient increase in value, the disqualified persons would be able to correct the excess benefit transaction without having to come up with additional cash.
To protect against abuse in the decisions surrounding the return of specific property, the Final Regulations require that the disqualified persons not participate in such decisions. Unlike the provisions of the Final Regulations regarding payment to a Section 509(a)(1) public charity, if the applicable tax-exempt organization no longer exists or is no longer tax-exempt, the provisions regarding payment by return of specific property do not prevent the disqualified persons (or persons related to them) from participating in management of the applicable tax-exempt organization after the correction transaction is completed.121 Thus, the Caraccis, in theory, could cause the S corporations to return the specific property to the Tax-Exempt Entities, and resume their previous role as managers of the Tax-Exempt Entities, so long as they were not involved in the entities’ decision to accept the return of the property.

On the facts here, however, the Caraccis may not be able to reacquire management of the Tax-Exempt Entities after a return of the specific property, without coming to some agreement with the Service on structure and operation of the Tax-Exempt Entities. Although there is no requirement that the Caraccis abstain from participation in the management of the Tax-Exempt Entities after correction, the Service may be able to argue that the entities no longer qualify as public charities. This is because their long period of dormancy may mean that they have ceased to meet the support tests necessary for public charity status under Section 509(a)(2).

If that is the case, the Tax-Exempt Entities will be private foundations. This has a number of consequences. First, under the private foundation rules, it will be difficult, if not impossible, for the Caraccis to run the home health agencies as private foundations. Second, once an entity is classified as a private foundation, it is not easy to reacquire public charity status. To requalify the Tax-Exempt Entities as public charities, the Caraccis could: (1) operate the entities so as to meet the requirements of Code Section 509(a)(1), (2), or (3) for a continuous period of sixty calendar months; (2) notify the Service before the start of the sixty-month period of the intent to requalify as public charities; and (3) establish immediately after the sixty-month period that the entities did indeed meet the requirements of Code Section 509(a)(1), (2), or (3) during that period.122 With the notice to the Service before the start of the sixty-month period, the Caraccis could request an advance ruling that the tax-exempt entities qualify as public charities.123 Issuance of this advance ruling is discretionary with the Service, based upon whether the
organizations can reasonably be expected to meet the requirements for requalifying as public charities during the sixty-month period.\textsuperscript{124} This discretion could, of course, give the Service substantial and significant input into how the Tax-Exempt Entities would be structured and operated after they reacquired tax-exempt status.

In sum, the return of specific property rules appear to work well for the return of a single asset like a parcel of real estate, but they do not work as well if the specific property consists of the assets of a going business. In this context, at least when the organizations involved continue to be public charities, the fact that the disqualified persons can participate in management of the applicable tax-exempt entity after return of the assets has significant potential for abuse. If the disqualified person or persons involved do not control the applicable tax-exempt entity, the potential for abuse is low. On the other hand, if the disqualified persons involved do control the entity after the return of the property, the potential for abuse is high.\textsuperscript{125} Especially when compared to the rules regarding payment to an established, wholly independent, Section 509(a)(1) entity, in which the disqualified person involved in the excess benefit transaction cannot also be a disqualified person with respect to the Section 509(a)(1) entity, the protection under the return of specific property rules is not very strong. Thus, this particular provision of the Final Regulations may have a potential weakness, and it will be interesting to see how the law develops in this area.\textsuperscript{126}

\textbf{VIII. Bargain Purchase Income in Addition To Excess Benefit Excise Tax Liability}

In addition to asserting excise tax penalties, the Service argued that the younger generation of Caraccis, who were stockholders in the transferee S corporations but, unlike their parents, were not “owners” of the Tax-Exempt Entities, received taxable compensation income as a result of their receipt of stock in the S corporations. The Tax Court rejected this approach, finding the receipt of stock to be gifts from their parents excludable from the children’s income under Section 102 of the Code rather than compensatory transfers from any of the corporations.\textsuperscript{127} While this is a good outcome for the Caracci children, it may not be such a great result for Victor and Joyce Caracci, because, given the court’s finding of a gift of substantial value, the Service may next confront the senior Caraccis with gift tax liability and associated issues if the applicable statute of limitations has not run.
The Tax-Exempt Entities are tax-exempt, Section 501(c)(3) Mississippi nonstock corporations. Nevertheless, the Tax Court described Victor and Joyce Caracci as being the “owners” of the entities at all times.\textsuperscript{128} It would seem that the premise that Joyce and Victor Caracci were the “owners” of the Tax-Exempt Entities is incorrect. “Ownership” by private individuals is a concept that is incompatible with nonprofit, tax-exempt status, and private individuals cannot “own” the assets of a Section 501(c)(3) organization, nor receive the right to receive any property for personal benefit except in exchange for adequate consideration (including performance of services) in return for the personal benefit.\textsuperscript{129}

It is difficult, therefore, to see how the senior Caraccis “owned” anything that they could “gift” to the junior Caraccis in a manner that would trigger the exclusion from income for gifts under Section 102 of the Code. If the senior Caraccis were not the “owners” of the Tax-Exempt Entities, then, despite the Service’s withdrawal of its appeal on this issue, the Tax Court’s approach to exclude assets from income as gifts under Section 102 of the Code is wrong. One cannot give away something one does not own to begin with; thus, the assets should not have been excluded from income—unless the transactions are characterized as a gift of embezzled funds resulting from the senior Caraccis directing the transfers from the Tax-Exempt Entities to the Caracci children, in which case the senior Caraccis might be liable for income tax as well as gift tax. Furthermore, whatever the validity of the Tax Court’s approach, the circumstances that allowed the “gift exclusion” analysis in \textit{Caracci} will not be present in many cases. As a result, the Tax Court’s decision on the income tax consequences should not undercut the Service’s ability to raise the income tax issue in the future.

This is not good news for taxpayers generally because it means that the Service’s argument that the younger Caraccis received compensatory income from the bargain transaction should apply with equal force to any disqualified persons similarly situated, at least to the extent that the Section 102 exclusion from income analysis is not available. The important point here is that the Service’s compensation logic can be applied to any bargain purchase excess benefit transaction and to many disqualified persons. Either the transaction could be deemed compensation and be taxable on that ground, or it could be construed to constitute embezzlement or theft, and in either event be found to be taxable income to the recipient.
Whatever theory is used to generate income, the consequences to the taxpayers could be extremely burdensome. In addition to the nondeductible 25% and 200% excess benefit excise tax penalties, income tax would be due on the excess benefit in the year of the initial transaction. Furthermore, any deduction for repayment of the excess amount would come many years later when it may provide no income tax relief (because of insufficient other income to shelter), even if the repayment results in an abatement of all or part of the excise tax penalties. How this law might develop remains to be seen, but the potential income tax risk provides an added reason to comply with the necessary procedures to avoid excess benefit transactions.

The compensatory income approach also has ramifications for the tax-exempt entity. Generally, the transfer of property to compensate someone for services constitutes a taxable disposition of the property by the transferor.\textsuperscript{130} Except to the extent that the stock of the corporation is debt-financed property,\textsuperscript{131} this typically would not be a problem for a tax-exempt entity.\textsuperscript{132} If the Service successfully revokes the exempt status of a transferor as it attempted in the \textit{Caracci} case, however, the transfer would be taxable, and the failure to have reflected the transfer as compensatory in the year of transfer could preclude an offsetting deduction.\textsuperscript{133} Furthermore, any compensatory transfer of stock to an employee would trigger a withholding requirement by the applicable tax-exempt entity.\textsuperscript{134} In the most extreme case, the recipient could be subject to excise taxes of 25% and 200%, as well as income tax at applicable rates, and the formerly exempt organization could be subject to a taxable gain on the transfer with no offsetting expense deduction.

Under this approach, both the offending taxpayers and the formerly tax-exempt entity might collapse under the tax burdens. For example, in \textit{Caracci}, if the Service had been successful on all potential counts, and if the disqualified persons did not or could not correct the transaction, excise tax penalties would have amounted to $11,619,000, and income tax and/or gift tax could have been applied on the amounts that the parents caused to be redirected to the children. Concern about this onerous level of taxation on the Caraccis could have been a contributing factor to the Tax Court’s willingness to go the extra mile in not revoking the Section 501(c)(3) status of the Tax-Exempt Entities.

\textbf{IX. Summary and Conclusions}

The \textit{Caracci} opinion is an interesting and important first attempt to apply the intermediate sanctions rules and to clarify
the now ill-defined interaction between the excise taxes under the intermediate sanctions regime and revocation of tax-exempt status. At a minimum, Caracci indicates that revocation will not be nearly as common as it was prior to the adoption of the intermediate sanctions provisions of the Code, and that courts are likely to bend over backwards to facilitate good-faith efforts by disqualified persons to correct excess benefit transactions. Caracci also teaches that contemporaneous and careful attention to detail regarding valuation issues is very important and that organization managers who make a good-faith effort to follow the rules set forth in the Final Regulations should be able to avoid imposition of the ten percent organization manager excise tax. Caracci also points out that the consequences of an excess benefit transaction may not end with excise taxes and correction but may extend to income taxes being imposed on the same excess benefit that triggered the excise taxes. Finally, Caracci stands as a stark warning for entrepreneurs beginning business ventures to think hard about the consequences before choosing the nonprofit, tax-exempt form of business because the value the entrepreneur creates belongs to the tax-exempt entity, not to the entrepreneur.

Endnotes

1 As used herein, the phrase, “intermediate sanctions regime,” refers to I.R.C. §§ 4958, 4961, 4962, 4963, 6684 (2002).
3 118 T.C. 379 (2002). The Caracci opinion arises out of a group of cases, sometimes referred to as the “Sta-Home Health Agency cases,” that involved eleven separate petitions filed in the Tax Court.

The term “disqualified person” means, with respect to any transaction:

(A) any person who was at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization,
(B) a member of the family of an individual described in subparagraph A, and
(C) a 35-percent controlled entity.

5 “Applicable tax-exempt organization” means organizations that are not private foundations under § 509(a) of the Code, and that have been described in § 501(c)(3) or § 501(c)(4) of the Code at any time during the five-year period ending on the date of the transaction involved. Id. § 4958(e).
6 As will be discussed, this choice of the nonprofit form of doing business was a fundamental mistake, and parties in the position of Victor and Joyce Caracci would be well advised to find alternative structures, such as a management contract arrangement, when faced with this kind of problem.
7 Caracci, 118 T.C. at 382.
8 At all relevant times for the dispute before the court, Joyce Caracci, her son, Michael Caracci, and her daughter, Christina McQuillen, were the sole
members of the Boards of Directors of each of the Tax-Exempt Entities. In addition, for each of the Tax-Exempt Entities: (1) Michael Caracci was the Chief Executive Officer; (2) Joyce Caracci was the Chief Operating Officer and Administrator; (3) Christina McQuillen was the Director of Personnel; (4) another son, Vincent Caracci, was the General Counsel; (5) Denise Caracci, Vincent Caracci’s wife, was employed as a nurse; and (vi) David McQuillen, Christina McQuillen’s husband, was employed as a maintenance man. Victor Caracci served as a consultant to the Tax-Exempt Entities. Id. at 382-83.

9 Id. at 385.
10 Id. at 384.
11 Id.
12 Caracci, 118 T.C. at 404. In 1995, Michael Caracci’s salary was $226,483, Joyce Caracci’s salary was $140,472, Vincent Caracci’s salary was $70,180, and Christina McQuillen’s salary was $64,514. Id. at 389.

13 Id. at 405.
14 Id. at 408, 413.
15 Id. at 383.
16 Id. at 386.
17 Caracci, 118 T.C. at 387.
18 Id.
19 Id.
20 The procedure was first set forth in the legislative history underlying TBOR2. See H.R. Rep. No. 104-506, at 56-57 (1996), reprinted in 1996 U.S.C.C.A.N. 1143, 1179. The procedure is now set forth in Treas. Reg. § 53.4958-6 (2002). Generally speaking, triggering the presumption requires: (1) approval by disinterested members of an authorized body of the applicable tax-exempt organization; (2) due diligence as to the comparability of the terms and conditions of the transaction to like transactions; and (3) adequate and contemporaneous documentation of the authorized body’s decisionmaking. Treas. Reg. § 53.4958-6(a)(1)-(3).

21 See id. § 53.4958-6(e) (2002):

The fact that a transaction between an applicable tax-exempt organization and a disqualified person is not subject to the presumption described in this section neither creates any inference that the transaction is an excess benefit transaction, nor exempts or relieves any person from compliance with any Federal or state law imposing any obligation, duty, responsibility, or other standard of conduct with respect to the operation or administration of any applicable tax-exempt organization.

In many jurisdictions, the sale of all of the assets of a tax-exempt organization, especially a healthcare organization, to for-profit entities owned and controlled by directors of the tax-exempt organization would have required disinterested approval, and, in addition, participation and approval by the state attorney general. See, e.g., OHIO REV. CODE ANN. §§ 109.34, 109.35 (West 2002) (governing the transfer of healthcare assets where the fair market value of the assets is 20% or more of the total assets of the entity or where the transferor is not able to fulfill its stated or actual purposes without the assets being transferred). See also OHIO REV. CODE ANN. § 1702.39(B)(1) (West 2002) (A “public benefit corporation,” which would include a charitable healthcare organization, may not dispose of its assets with value equal to more than 50% of the fair market value of the net tangible and intangible assets, including goodwill, of the corporation in a transaction that is outside the ordinary course of business or that is not in accordance with the purposes for which the
corporation was organized, as set forth in its articles, without obtaining advance approval from a court or from the Ohio Attorney General).

In Mississippi, however, such a process was apparently not required. The pertinent statute, MISS. CODE ANN. § 79-11-269 (2002), provides only that conflict of interest transactions are not voidable solely because of a director's conflict of interest if the transaction was “fair” to the organization at the time it closed, and there do not appear to have been other provisions of Mississippi law or practice that required any further review by disinterested parties.


24 Caracci, 118 T.C. at 388.


26 Id. § 4958(a)(1), (b).

27 Id. § 4958(a)(2).

28 Caracci, 118 T.C. at 381-82.

29 Id. at 413-14.

30 Id. at 416-17.


34 Id. § 4958(f)(1). In this context, a person’s family is limited to the person’s: (1) spouse; (2) siblings and their spouses (by whole or half blood); (3) ancestors; and (4) children, grandchildren, great grandchildren, and their spouses. Id. §§ 4958(f)(4), 4946(d).

35 Id. § 4958(a)(1), (c)(1)(B).

36 Id. § 4958(b), (f)(5).

37 I.R.C. § 4958(f)(6) (2002). As discussed below, under the Final Regulations, with two exceptions (for the return of specific property and for organizations that have ceased to exist or that are no longer tax-exempt), the disqualified person corrects the transaction by paying the applicable tax-exempt organization an amount equal to the excess benefit, plus interest thereon from the date of the excess benefit transaction to the date of correction, at the applicable federal rate for that time period as in effect at the date of the excess benefit transaction. See Treas. Reg. § 53.4958-7(b)(1), (c) (2002).

38 I.R.C. § 4958(d)(1).

39 Organization manager means any officer, director, or trustee of an applicable tax-exempt organization, or any individual having similar responsibilities. Id. § 4958(f)(2).

40 Id. § 4958(a)(2).

41 Id.

42 Id. § 4958(d)(1).

43 Part VI, Line 89b, of Form 990 asks the following question: “Did the organization engage in any section 4958 excess benefit transaction during the year or did it become aware of an excess benefit transaction from a prior year? If “Yes,” attach a statement explaining each transaction.” If the organization responds “Yes” to the question posed on Line 89b, the Instructions to the Form 990 direct the organization as follows: “Attach statement describing any excess benefit transaction, the disqualified person or persons involved, and whether or not the excess benefit transaction was corrected.” See generally

44 Currently, only transactions that constitute excess benefit transactions are required to be disclosed on Form 990. But see I.R.S. Announcement 2002-87, 2002-39 I.R.B 624, available at www.irs.gov/pub/irs-irbs/irb02-39.pdf (last visited Dec. 26, 2002) (seeking public comment on whether any transaction between a tax-exempt organization and a disqualified person should have to be disclosed on the Form 990). As a result, it may be that the Service will begin to require such disclosure sometime in the future, perhaps as early as 2003, whether or not the transaction qualifies as an excess benefit transaction.

45 I.R.C. § 4961(a) (2002). In this context, “correction” has the same meaning as specified in Section 4958(f)(6) of the Code, and a correction is “timely” if it occurs within 90 days after any determination that the tax is due becomes final. See id. § 4963(d)(1), (e)(1).

46 Id. § 4962(a) (2002).


49 Boyle, 469 U.S. at 246; Treas. Reg. §§ 53.4958-1(d)(6), 53.4941(a)-1(b)(5), 301.6651-1(c) (2002).

50 Treas. Reg. § 301.6684-1(b) (2002). Under the applicable Treasury Regulations, reasonable cause must be shown in a written statement, signed under penalties of perjury, setting forth the facts and circumstances constituting reasonable cause. Id.

51 Id. §53.4958-1(d)(9).

52 Id. §§ 301.6684-1(c), 1.507-1(c)(2), -1(c)(5). For a recent application of Section 6684 of the Code, see Priv. Ltr. Rul. 2002-43-057 (July 2, 2002) (dealing with the imposition of both the Section 4958 disqualified person and organization excise taxes and the 100% penalty under Section 6684 of the Code). This ruling illustrates the kinds of egregious behaviors likely to encourage the Service to assert the 100% penalty under Section 6684 of the Code. See also Lawrence M. Brauer & Leonard J. Henzke, Intermediate Sanctions (IRC 4958) Update, in IRS EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FY 2003, at E-53 & 54, available at www.irs.gov/pub/irs-tege/eotopice03.pdf (last visited Dec. 14, 2002).


54 Id.


56 Id. § 4958(a)(2).


59 Boyle, 469 U.S. at 246; Treas. Reg. § 53.4958-1(d)(6).

60 Caracci, 118 T.C. at 386-88.

61 Id. at 387.


63 Id. § 53.4958-1(d)(9).

64 Id. § 53.4958-1(d)(4)(iii).

65 Id. § 53.4958-1(d)(4)(iv).

66 Id. § 53.4958-1(d)(5).

Intermediate Sanctions


Caracci, 118 T.C. at 391-92.

Id. at 394-95.

Id. at 409.

Id. at 391-92.


Caracci, 118 T.C. at 416.

Id.

Id. at 381-82. See also Treas. Reg. § 1.501(c)(3)-1(c)(1) (2002).


Caracci, 118 T.C. at 417.

Id. (quoting H.R. REP. NO. 104-506 at 106 n.15) (emphasis added).

Caracci, 118 T.C. at 417.

Id.

Id.

Id. at 418.

Id.

Caracci, 118 T.C. at 417.

This is essentially the standard suggested by the Comment on the Intermediate Sanctions submitted by representatives of the Exempt Organizations Committee of the (ABA’s) Section of Taxation and the Tax and Accounting Interest Group of the Health Law Section. Letter from Richard M. Lipton, Chair, Section of Taxation, and Patricia Meador, Chair, Health Law Section, to The Honorable Charles O. Rossetti, Commissioner, Internal Revenue Service (Apr. 16, 2001), available at http://pubs.bna.com/ip/BNA/DTR.NSF/ c98e8e3e40465cc885256743006de6cd/8525643007e2c8d85256ae0083cf6a?OpenDocument. The ABA Comments suggested a facts and circumstances approach, with the underlying principle being whether the transaction or transactions involved were aberrational and unlikely to recur. The ABA Comments then went on to suggest a list of eight non-exclusive factors that should be considered in all cases. Those factors are as follows:

(1) The number, frequency, size, extent, willfulness and flagrancy of the excess benefit transactions;
(2) The adoption of procedures and safeguards by the organization, whether before or after the occurrence of any excess benefit trans-
action, that are reasonably calculated and sufficient to prevent the occurrence of future excess benefit transactions;
(3) The likelihood that excess benefit transactions involving the organization may recur with or without the adoption of such procedures and safeguards;
(4) The extent and success of the organization's regular and ongoing programs and activities that substantially further charitable, educational, religious or other tax-exempt purposes;
(5) The impact on the ability of the organization to further charitable, educational, religious or other tax-exempt purposes if the organization's tax-exempt status is revoked;
(6) The proportionality of the consequences of revocation of tax-exempt status to the excess benefit transactions.
(7) The degree of oversight of the organization provided or to be provided by state and local governmental authorities, recognized independent nonprofit accreditation agencies, recognized independent nonprofit national governing bodies or associations or the like; and
(8) All other relevant facts and circumstances.

When the entity in question is a functioning entity, this approach is also consistent with the approach the Service set forth in the Preambles to the Proposed Regulations and Temporary Regulations to Section 4958. See Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes of Excess Benefit Transactions, 63 Fed. Reg. 41,486, 41,488-89 (Aug. 4, 1998). There, the Service stated that in determining whether an excess benefit transaction rises to the level that it causes the organization, on the whole, to cease functioning as a tax-exempt organization, "factors relating to the organization's general pattern of compliance with the requirements of section 501(c)(3) . . . will be taken into account. These factors would include whether the organization has been involved in repeated excess benefit transactions . . . ." Id.


I.R.C. § 4961(a) (2002). In this context, a correction is timely if it occurs within ninety days after any determination that the tax is due becomes final. See id. § 4963(d)(1) & (e).


Boyle, 469 U.S. at 245.

See Treas. Reg. § 53.4958-7(b)(1), (c) (2002).


On the other hand, if the Final Regulations are construed to allow the assets of a going business to be “specific property” within the meaning of the Regulations, permitting the return of specific property to the tax-exempt organization that the disqualified persons may continue to control leaves open the possibility of abuse. The Final Regulations may not adequately protect against abuse in this type of circumstance.


Id.


Caracci, 118 T.C. at 413, n. 11.


See id. § 4958(f)(6).

On the other hand, perhaps the Caraccis can argue that the fact that the excess benefit transaction took place prior to the effective date of the Regulations
means that all events relating to that transaction are governed by the rules (or lack thereof) in place at the time of the excess benefit transaction. This reading could be justified in order to prevent the consequences of the excess benefit transaction from being retroactively controlled by rules not in place at the time the transaction took place, and it would be particularly persuasive if the rules that came into effect after the excess benefit transaction occurred were more restrictive than the rules in place when the transaction occurred. In Caracci, however, more liberal rules were in effect at the time of trial than on the date the excess benefit transaction occurred.

The amount of the interest charged is determined by multiplying the excess benefit by an interest rate, compounded annually, for the period from the date the excess benefit transaction occurred to the date of correction. The interest rate used must be a rate that equals or exceeds the applicable federal rate (AFR), compounded annually, for the month in which the transaction occurred. The period from the date the excess benefit transaction occurred to the date of correction is used to determine whether the appropriate AFR is the federal short-term rate, the federal mid-term rate, or the federal long-term rate. Id. The excess benefit transaction in Caracci occurred in October of 1995, which, assuming the Caraccis make correction eight years after the excess benefit transaction, means the mid-term rate is used to compute the interest component. The mid-term rate in effect in October of 1995 was 6.31%. See Rev. Rul. 95-67, 1995-41 I.R.B. 29 (Oct. 10, 1995). Therefore, the Caraccis' correction amount at the eight-year point would be approximately $8,425,180 (the excess benefit amount of $5,146,000, plus interest thereon of 6.31%, compounded annually).

The after-tax cost of correction may be reduced somewhat to the extent that the disqualified persons may amortize any amount representing an increase in the purchase price of the property and deduct any interest.

Furthermore, because the anti-abuse rule appears to apply only to avoidance of the cash only general rule, it does not appear that it will be available to the Service to prevent abuse in the return of specific property transactions.


Id.

For example, it is perfectly possible that a disqualified person in the shoes of the Caraccis could, without the requirement for approval by the Service, arrange for a "friendly" independent board to deal with the return of the assets. This board could then resign and arrange for the return of the
disqualified persons to control of the applicable tax-exempt organizations. In some instances, such a process might be appropriate and in the best interests of the applicable tax-exempt organization. In others, it could lead to a reoccurrence of the kinds of problems that lead to the initial excess benefit transaction.

126 In such a case, the participation of the state attorney general to oversee the process would go a long way toward filling in the gap in protection of the charitable class left by the Final Regulations.


128 Id. at 382.

129 Under the Treasury Regulations, the assets of a § 501(c)(3) organization are, in effect, impressed with a trust for the benefit of the charitable class that it serves. The regulations require that the articles of all § 501(c)(3) organizations to have an appropriate dissolution clause; that the organization be operated exclusively for charitable purposes; that the organization be operated for a public purpose rather than a private purpose; and that no part of the net earnings of the organization inure to the benefit of private persons. See Treas. Reg. § 1.501(c)(3)-1(b)(4), (c)(1)-(2), (d)(1)(ii) (2002). Thus, in a 1969 Revenue Ruling, the Service concluded that a transaction did not qualify for tax-free treatment under § 355 of the Code because the “continuity of interest” requirement under § 355 requires that the shareholders have a “proprietary” interest and that “the shareholders had no proprietary interest in X after it became a nonprofit, membership corporation exempt from Federal income tax, the transaction does not meet the continuity of interest requirements of the regulations under section 355 of the Code.” See Rev. Rul. 69-293, 1969-1 C.B. 102 See generally MICHAEL W. P EREGRINE & J AMES R. SCHWARTZ, THE APPLICATION OF NONPROFIT CORPORATION LAW TO HEALTHCARE ORGANIZATIONS (2002).

130 See I.R.C. § 311(b) (2002).

131 See id. § 514.

132 See id. § 512(b)(5).

133 This presumes that the Service successfully revokes the organization’s exempt status as of the time of the transaction and the transaction is accounted for within the taxable period. Exempt status might, of course, be revoked as of some time post-transaction, rendering the transaction itself not taxable to the organization.

134 In addition, under Treas. Reg. § 53.4958-4(c)(1) (2002), failure to treat a transaction as compensatory in the year of transfer also precludes the argument later that any excess benefit constitutes reasonable compensation.