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MULTIMILLION-DOLLAR TAX ON EXCESS BENEFITS OVERTURNED

LITIGATING EXCESS BENEFIT CASES

Although the excess benefit rules in Section 4958 of the Internal Revenue Code have been in effect for more than 10 years, very few of the assessments levied or threatened by the IRS have resulted in litigation. That is likely to change if recent IRS initiatives such as the focus on executive compensation continue. Now, with the release of the first appellate court opinion on Section 4958 issues, exempt organizations, their management, and those who contract with the organizations have a higher degree of clarity on what can be done to protect against liability for the 225 percent excise taxes under Section 4958.

OVERVIEW OF STA-HOME CONVERSION AND AUDIT

In *Caracci v. Commissioner,* the IRS assessed the full scope of excise taxes against the founders and their families for the sale of the home health agency assets of three Mississippi nonprofits (collectively "Sta-home") to new Subchapter S corporations owned by the Caraccis. The nonprofits had been operating at a loss since 1987, and the loss had been increasing for five straight years. Given the 95 percent to 97 percent Medicare patient base, the cap on Medicare payments at actual cost (and an average disallowance rate of 0.7 percent below that), and the need to hold back employee compensation to provide working capital for the nonprofits, the Caraccis concluded it would not be possible to continue the home health business without a sale or infusion of capital. At the end of fiscal 1995, Sta-home had a net worth of negative $1.4 million.

The Caraccis consulted with legal counsel experienced in home health agency work, who advised that they convert Sta-home to for-profit status, which they ultimately did after unsuccessful attempts to sell the agency to a hospital. An independent valuation obtained at the time of the conversion concluded that the liabilities of Sta-home exceeded the fair market

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value of its assets. Consistent with that appraisal, in return for the assets, the Subchapter S corporations agreed to assume all of the liabilities associated with the transferred assets. There was no additional cash consideration paid.

On audit, the IRS disagreed with the valuation, concluding that the assets were in fact worth approximately $18.5 million more than the liabilities assumed by the Subchapter S corporations and that the excess was a taxable excess benefit to the Caraccis. In the Tax Court, the IRS relied on, among other things, a variety of for-profit comparables, the potential for turning a profit by eliminating certain employee bonuses, and the value of the business to prospective hospital purchasers. As a result of the higher valuation, the IRS assessed penalty excise taxes totaling approximately $46.5 million, assessed additional income tax liability against the Caracci children related to the transfer of stock in the new Subchapter S corporations, and revoked Sta-home's tax-exempt status.

Sta-home and the Caraccis challenged the assessments and the revocation. The Tax Court overturned the revocation and the income tax assessment but upheld the Section 4958 excise tax assessment for excess benefits in a reduced amount of $5.164 million, reflecting a reduced valuation computed by the court at $11.6 million. The Caraccis appealed to the Fifth Circuit.

TAXPAYERS PREVAIL ON APPEAL

The Fifth Circuit opinion resolving the *Caracci* case is in large part a tale of two series—a series of fortunate choices for the taxpayers and a series of unfortunate choices for the IRS. For their part, the Caracci family sought out and followed expert advice of attorneys with substantial experience in nonprofit to for-profit conversion of home health agencies, obtained a contemporaneous appraisal of Sta-home's assets, and retained a valuation expert for trial who had substantial experience in valuing home health agencies. By comparison, the IRS moved forward too quickly to assess excise taxes when faced with an expiring statute of limitations and taxpayers who may have been about to take corrective action, relied on an interim valuation report to make the assessment (which the IRS effectively admitted was excessive after defending it for approximately four and a half years), and selected an appraiser who had little if any experience in valuing home health agencies according to the court and who failed to focus on the Sta-home entities' specific circumstances. It is from these two series of choices that the exempt organization community can glean eight valuable lessons in protecting against excise tax liability for excess benefit transactions.

Lesson One: It Pays to Seek Experienced Legal Counsel and Valuation Experts. At least with respect to new rules in the exempt area, it pays not to stand out from the crowd, and it pays to seek out experienced legal and tax counsel—even if the IRS later disagrees with the advice. The Fifth Circuit's opinion notes that the Caraccis retained an attorney who was a recognized expert in legal issues relating to home health agencies in Mississippi, that the attorney advised all of his exempt home health agency clients to convert to nonexempt status, and that most followed his advice—typically by transferring assets to newly formed Subchapter S corporations in exchange for an assumption of liabilities.

Lesson Two: Obtain Independent Valuations for Major Transactions With Insiders. There was no dispute that the Caracci family and its new Subchapter S corporations were insiders and disqualified persons with respect to Sta-home. Supporting the transaction with two independent appraisals was a prudent, if expensive, business step. The Caraccis retained a tax attorney whose firm obtained two contemporaneous appraisals of the assets and liabilities. Those valuations later proved to be key components of avoiding millions of dollars of excise tax liability and preserving Sta-home's exemption. The court noted that the valuations both showed that Sta-home's liabilities exceeded the value of its assets.

The Fifth Circuit's heavy reliance on the effort and experience of one of the Caracci appraisers serves to illustrate that it is indeed a "best practice" to obtain independent valuations contemporaneously for all significant transactions with undisputed insiders (in addition to being helpful in other cases), even if the IRS later disagrees with the valuation. In *Caracci,* the IRS disagreed significantly with the valuation, but the Fifth Circuit panel sided with the Caracci family.

Lesson Three: Economic Survival of the Nonprofit Mission Is Important. Notwithstanding prior suggestions from the IRS to the contrary, survival of the exempt organization's mission to serve the community is a relevant consideration in Section

4958 cases, at least where there is independent support for the conclusion, the organization is not violating criminal laws, and other alternatives are explored first. If other courts follow this approach, it would be a welcome clarification for many struggling nonprofit organizations.

In this respect, *Caracci* is also a departure from the direction of prior IRS guidance in GCM 39862. In GCM 39862, in analyzing the inurement and private benefit consequences of certain net revenue stream joint ventures, the IRS essentially disregarded the argument that the joint ventures were essential to the survival of the nonprofit. In the *Caracci* case, the court attached some significance to both the history of losses and the lack of alternatives for continuing the Sta-home business in a nonprofit form. In analyzing the possibility of any excess benefit, the court noted that the valuations obtained by the Caraccis demonstrated a lack of positive fair market value for the home health agencies in light of their continuing and increasing loss history, and that the valuations supported the Caraccis' conclusion that without an infusion of more cash and capital, Sta-home likely would go out of business. As a result, many relatively poor, rural areas would lose their major provider of home health services. Moreover, before proceeding with the conversion, the Caraccis did explore other alternatives, including a sale to area hospitals. All of those efforts were unsuccessful.

Lesson Four: "Comparable" Means More Than "Same Line of Business." The Fifth Circuit opinion emphasizes that key characteristics of companies have to be substantially similar to the target company being valued in order for the companies to be "comparable" and useful in a market approach to valuation. Simply adjusting multipliers that were applied to other companies was not enough in this case to make various profitable public companies comparable to Sta-home where those other companies did not have even close to the substantial Medicare patient base of Sta-home (and associated profit restrictions), and those other companies were actually profitable (versus Sta-home's continuing history of losses).

Lesson Five: Speculative Future Events Do Not Necessarily Equal Current Value. The mere potential for future profits was not a sufficient basis for a current valuation of Sta-home. The Tax Court opinion had relied heavily on the potential for profitability by eliminating employee bonuses and thereby potentially erasing the operating losses. It failed to recognize, however, that these "bonuses" were not discretionary payments but rather deferred payments of amounts owed to employees that had been withheld to provide working capital for Sta-home, and that if the payments were not made, there would have been a dollar-for-dollar reduction in Medicare reimbursement, thus continuing the same level of losses. Similarly, the approval of a certificate of need to expand the money-losing Medicare services did not suggest profit potential.

Lesson Six: Carefully Weigh Pros and Cons of Extending the Statute of Limitations. Historically, it has been very common for the IRS to seek a waiver of the statute of limitations on audit to buy more time to work up the facts and legal analysis of an issue. Although many taxpayers consent to those requests in hopes of maintaining a good working relationship and rapport with the exam team, others call the question on liability early by refusing to extend the statute of limitations, thereby forcing the IRS to make an assessment or let the transaction go with no excise tax. In the *Caracci* case, that gamble ultimately paid off. As happens frequently when the extension is denied, the IRS apparently issued an assessment on the best available information, in this case an interim valuation report.

The Fifth Circuit, however, lambasted the IRS for relying on a brief intermediate valuation report that had an express caveat cautioning that the valuation was only intermediate and a final economic report had to be done. In the court's view, the IRS exacerbated that problem by not admitting the error until trial and by rushing to assess taxes not only to stave off a statute-of-limitations problem, but to close the door on any opportunity for the Caraccis to correct the excess benefit. In the end, the Caraccis' unwillingness to extend the statute weighed in their favor, in this case by effectively forcing the IRS into the first of a series of unfortunate choices—assessing taxes based on an incomplete and inaccurate valuation. The Fifth Circuit found that the Tax Court's failure to recognize that this arbitrary and erroneous valuation shifted the burden to the IRS to prove the correctness of the assessment, and the IRS's failure to provide that proof after most of its supporting valuation was rejected, should have resulted in a verdict for the Caraccis. Whether or not to extend the statute of limitations, however, must be evaluated on a case-by-case basis, and not extending can have its own downsides in the length and cost of the legal fight.

Lesson Seven: Reasonable Interpretations Should Govern Prior to Issuance of Regulations. The timing of the *Caracci* case cannot be ignored. The conversion was approved by the Sta-home board more than two months before legislation including Section 4958 was introduced, the conversion was consummated before Section 4958 was finally enacted into law, and regulations were not even issued in proposed form until more than two years later. Although the Fifth Circuit did not expressly rely on these timing elements in finding for the Caraccis, they may have had some influence on the court's approach to this case.

Lesson Eight: Who Has the Burden of Proof Is Important. A frequent question in the industry has been how important it is to shift the burden of proof to the IRS by following the rebuttable presumption procedure. Although the Fifth Circuit did not focus on the rebuttable presumption, the court did provide a clear illustration of the importance of the burden of proof in tax cases. In this case, errors in the IRS's initial valuation shifted the burden of proof to the government to support the accuracy of the assessment. The court did not remand this case; rather, it took the somewhat unusual step of reversing and rendering a final decision for the Caraccis, finding that the record established as a matter of law that there was no "net excess benefit" (a reference in part to the failure of the IRS to carry the burden of proof with an appropriate valuation).

NEXT STEPS FOR THE IRS AND THE CARACCIS

The IRS still may seek a rehearing before the full panel of the Fifth Circuit and ultimately may appeal the case to the Supreme Court. The IRS may prefer, however, to wait for a stronger case to take to the Supreme Court. For their part, the Caraccis may have an opportunity to recoup some of their costs by pursuing an award of attorneys' fees from the IRS.

LAWYER CONTACTS

We would be glad to talk with you regarding the way your organization addresses potential excess benefit transactions. For further information, please contact your principal Firm representative or one of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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