



CARACCI DRIVES HOME LESSONS ON EXCESS

Harsh criticism comes as excessive benefits to insiders may be due for intensified scrutiny.

BENEFIT RULES

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After more than two and one-half years of considering its decision, the Fifth Circuit finally issued its opinion in *Caracci*, 98 AFTR2d 2006-5264 (CA-5, 2006).¹ From the Service's perspective, the news was not worth the wait. The Caracci family won outright in a decision that severely criticized the Service's conduct of the audit and the findings of its valuation expert. The government did not seek a rehearing by the Fifth Circuit, nor did it file a petition for a writ of certiorari with the Supreme Court. Indeed, one IRS official noted that although the Service intends to pursue other excess benefit cases where appropriate, "there will be no further litigation in the *Caracci* case."² One wonders, however, whether the IRS will issue more specific guidance on valuations for Section 4958 purposes in *Caracci*'s wake.

Although the excess benefit rules in Section 4958 have been in effect for over ten 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. In 2005, for example, the IRS distributed approximately 1,800 compliance check and audit letters asking exempt organizations a series of questions about executive compensation.³ Then in 2006, the IRS distributed a community benefit questionnaire to approximately 600 hospitals nationally, again asking (in part) about executive compensation.⁴ At the same time, the

Senate Finance Committee chairman has expressed continuing interest in how the IRS is policing compliance with Section 4958, including compliance regarding executive compensation and other insider transactions.⁵

It is likely that some of these reviews and Congressional inquiries ultimately will result in attempts to assess excise taxes for excess benefit transactions under Section 4958. Now, with the release of the first appellate court opinion on Section 4958 issues, exempt organizations, their management, and those who contract with such organizations have greater clarity on what can be done to protect against liability for the potential excise taxes of up to 225% under Section 4958. Although the decision involved a sale of property rather than compensation arrangements, the court's reasoning holds many lessons for both types of transactions.

Overview of Sta-home conversion and audit

The *Caracci* case involved the conversion to for-profit status of three nonprofit home health agencies (collectively, the "Sta-home" agencies) organized by Joyce and Victor Caracci. The Caraccis formed the Sta-home agencies in 1976-77 as nonprofit corporations. The agencies had to qualify for Section 501(c)(3) status to

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**IT PAYS TO
SEEK
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become Medicare-certified (a requirement that was removed in the 1980s). When they were formed, the Sta-home agencies were funded with loans secured by a mortgage on the Caraccis' home. It is also noteworthy that Mississippi required a certificate of need (CON) to operate a licensed home health agency. The state had placed a moratorium on granting new home health licenses in 1983 (and still in effect at the time of the conversion), and Michael Caracci had lobbied to keep that moratorium in place. From 1986-93, the home health business grew 340% in Mississippi and only doubled nationally, yet no new home health agencies entered the market in Mississippi.

In anticipation of changes in Medicare reimbursement in the 1990s that would further restrict Sta-home's cash flow, the Caraccis sought the advice of legal counsel and were advised to convert to for-profit status. Their counsel retained tax counsel to assist with the conversion and they also obtained two appraisals confirming that the Sta-home agencies, all of which had a history of losses, had no positive value. In fact, the agencies had withheld (or deferred) pay from employees in order to have sufficient cash flow to operate.

Despite the Caraccis' precautions, the IRS elected to challenge the conversions on audit. It assessed the full scope of Section 4958 excise taxes against the founders and their family for the sale of the home health agency assets of the three Sta-home agencies to new S corporations owned by the Caraccis. The nonprofits had been operating at a loss since 1987, and the loss had increased for five straight years. Given the 95%-97% Medicare patient base, the cap on Medicare payments at actual cost (and an average disallowance rate of 0.7% 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, and were advised to convert Sta-home to for-profit status, which they ultimately did after unsuccessful attempts to sell to a hospital. An independent valuation obtained at the time of the conversion concluded that the liabilities of Sta-home exceeded the fair market value of its assets. Consistent with that appraisal, the S corporations

agreed to assume all of the liabilities associated with the transferred assets in return for receiving those assets. There was no additional cash consideration paid. The terms were supported by a contemporaneous appraisal from a local CPA, though his omission of intangible assets was questioned by the Caraccis' tax attorneys. The terms also were supported after the fact by the taxpayers' trial expert, who concluded that the home health businesses had a negative value.

On audit, the IRS disagreed with the Caraccis' valuations, concluding that the Sta-home assets were in fact worth approximately \$18.5 million more than the liabilities assumed by the S corporations, and that the excess was a taxable excess benefit to the Caraccis. In the Tax Court, the IRS relied, among other things, on 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 S corporations, and revoked Sta-home's tax-exempt status retroactive to the date of the sale on inurement and private benefit grounds.

The Tax Court decision

Sta-home and the Caraccis challenged the assessments and the revocation in the Tax Court. In a split decision, the 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 \$5,164,000, reflecting a reduced valuation computed by the court at \$11.6 million.⁶ In

¹ Oral argument in the case was held in the first week of October 2003.

² Sturges, "IRS Officials Detail EO Priorities, Plans for Ensuring Nonprofit Provider Compliance," 15 Health Law Reporter (BNA) 1061 9/21/06.

³ Materials from the IRS phone forum describing the results of the executive compensation initiative can be found at: <http://www.irs.gov/charities/article/0,,id=158408,00.html>.

⁴ The community benefit questionnaire can be found at: http://www.irs.gov/pub/irs-tege/eo_hospital_questionnaire_sample.pdf. For a summary of the questionnaire, see Griffith, "IRS Launches Community Benefit Initiative," 18 Exempts 32 (July/Aug 2006).

⁵ See Press Release: "Grassley Solicits IRS Comment, Urges Enforcement on Series of Problems in the Tax-exempt Arena" (6/1/06), available at <http://finance.senate.gov>.

⁶ Caracci, 118 TC 379 (2002).

other words, the IRS scored a victory on the intermediate sanctions issue, but with a net tax bill of only about 25% of what it had assessed.

Although the IRS had also assessed the 10% organization manager tax, it made a wise strategic decision to drop that argument in the Tax Court, probably because it did not believe it could establish that board action taken in reliance on advice of counsel and an independent CPA was "without reasonable cause" (the standard for imposing liability on organization managers for the 10% tax). By fighting the assessment vigorously, the taxpayers also were able to shave three-fourths off the assessment; however, they were still facing a significant tax bill (approximately \$1.25 million for the first-tier 25% tax and approximately \$10 million for the second-tier 200% tax).

The key aspect of the Tax Court decision was the court's handling of the fair market value issue. The court rejected parts of the valuations of both the Service's and the taxpayers' independent experts and made its own determination of value, finding that the net fair market value of the business was only about \$5 million. Issues with the IRS appraisal included failure to properly adjust the value for liabilities of the home health businesses and their capital structure (including the court's conclusion that four of six weeks of pay routinely withheld from employees should be treated as a long-term loan, with the float on the money representing invested capital). The court also noted several problems with the conclusions of the taxpayers' expert due to inconsistencies, unrealistic assumptions or multiples, and ignoring or undervaluing significant intangible assets. Despite the prolonged loss history relied on heavily by the taxpayers, the court found that the home health agencies had a net fair market value in excess of \$5 million. Among the assets to which the court ascribed value were the CON/license (due to the state moratorium on new licenses), work force in place, and the nonprofits' reputation.

In allowing the Sta-home agencies to keep their exempt status, the Tax Court relied heavily on the legislative intent that intermediate sanc-

tions generally should be the sole penalty for excess benefit transactions, unless the excess benefit rises to a level that indicates that the organization as a whole is not operated for exempt purposes. The court found that revocation here was inappropriate under that standard because (1) the excess benefit resulted from a single transaction for which the intermediate sanctions were being assessed; (2) the nonprofits were dormant, so that after the transaction they had done nothing inconsistent with exemption; and (3) preserving exemption was reasonably necessary to allow the disqualified persons to "correct" the excess benefit transactions by making the nonprofits whole financially.⁷

The Service's own factors for assessing revocation—from the preamble of the final regulations⁸—would attach significance to the isolated nature of a transaction. The more surprising element is that the court did not place more significance on the magnitude of the excess benefit transaction (i.e., \$5 million and 100% of the nonprofits' operating assets). While there was no affirmative corrective action in this case, the court's focus on post-transaction conduct can be taken as a lesson that a nonprofit's subsequent behavior will be relevant in determining whether exemption should be revoked.

The last factor in the court's analysis—affording a full opportunity for correction—may have been eliminated as a concern in future cases by regulations issued after the Tax Court case was filed (but before a decision) that address correction when a nonprofit is no longer exempt.⁹ Unstated but perhaps equally important was that, at the time of the conversion, the nonprofits' actions were consistent with advice of counsel and the appraisal of an independent CPA (albeit one the court rejected). The Tax Court essentially created an isolated transaction exception for inurement, though the IRS may challenge this exception in similar cases in the future where the facts are more in the government's favor. In this case, however, the IRS conceded the exemption issue by withdrawing the cross appeal it had filed with the Fifth Circuit on the Sta-home entities' exempt status.



OBTAI N INDEPE NDENT VALUATI ON FOR MAJOR TRANSA CTI ONS WITH INSIDERS.

Taxpayers prevail on appeal

The Caraccis appealed the excise tax decision to the Fifth Circuit. The Fifth Circuit opinion resolving the *Caracci* case is in large part a tale of two series—a series of fortunate choices by

⁷ The court did not endorse the taxpayers' arguments that the revocation and penalty excise taxes were the result of national origin discrimination, retaliation for past complaints, or selective prosecution.

⁸ TD 8978, 2002-1 CB 500; TD 8920, 2001-8 IRB 654 (Temp. Regs.).

⁹ Reg. 53.4858-7(e).



ECONOMIC SURVIVAL OF THE NONPROFIT MISSION IS IMPORTANT.

the taxpayers and a series of unfortunate choices by the IRS. 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.

For their part, the Caracci family made several choices that found favor with the Fifth Circuit. They sought out and followed the expert advice of attorneys with substantial experience in nonprofit to for-profit conversions of home health agencies, obtained two contemporaneous appraisals of Sta-home's assets, and retained a valuation expert for trial who had substantial experience in valuing home health agencies. The Fifth Circuit also noted that the Caraccis tried unsuccessfully to solicit other purchasers for the Sta-home agencies, including a hospital. All were "uninterested," and the most likely purchaser had already acquired another home health agency the year before. Moreover, although value generally should be determined as of the date of the transaction, the Fifth Circuit noted that after the conversion, the home health agencies continued to operate in the same manner as they did in the nonprofit setting, and continued to be subject to the same Medicare payment limitations that restricted their profitability.

By comparison, the Service's choices were unfortunate at best. For one, the Fifth Circuit clearly believed that 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. In addition, the IRS relied on an interim valuation report to make the assessment (which the IRS effectively admitted was excessive after defending it for approximately 4-1/2 years). The Fifth Circuit noted that the Service's own expert admitted that the assessments issued "were 'excessive,' 'incorrect,' and 'erroneous.'"

The IRS also selected an appraiser who, said the court, had little, if any, experience in valuing home health agencies and failed to focus on the Sta-home entities' specific circumstances. In its opinion, the Fifth Circuit lauded the in-depth review conducted by the Caraccis' expert (whom the IRS had unsuccessfully tried to hire as its expert). The court noted that the Caraccis' expert spent eight weeks in Mississippi studying the Sta-home assets and liabilities, whereas the Service's expert spent only two days in the state, one of them in a hotel room tracking lost luggage (though there

seems to be some question about how much the Caraccis cooperated with the Service's expert).¹⁰ Although the Caraccis' expert was experienced in valuing home health agencies, the Fifth Circuit noted that the Service's expert had no prior experience in the home health industry and instead "relied on his general valuation knowledge and experience" and one day of interviews with Sta-home's CFO.

The Fifth Circuit was critical of the Tax Court for ignoring the findings of both valuation experts and substituting its own judgment on value. In that regard, Sta-home's extended history of losses with no prospect of improvement in the Medicare business (which made up 95%-97% of its revenues), was ultimately very persuasive with the Fifth Circuit. It essentially concluded that without positive net revenues, the various intangible assets of Sta-home did not create a positive fair market value.¹¹

The Fifth Circuit also was highly critical of the IRS expert's selection of comparable companies. Most had a history of profitability, had substantially smaller Medicare businesses in proportion to their private pay businesses, and were significantly larger than Sta-home. Simply reducing the multiplier did not, in the Fifth Circuit's view, make the other home health agencies comparable to Sta-home. As the Fifth Circuit noted, "the valuation method must take into account, and correspond to, the attributes of the entity whose assets are being valued."¹² The Supreme Court has indicated, however, that a regression analysis can be an appropriate means of comparing values if all material variables are accounted for, e.g., in determining compensation by reference to larger companies.¹³

In addition, the Fifth Circuit criticized the Tax Court's reliance on the withheld employee compensation as erstwhile profit. As the court noted, if the Sta-home agencies had not paid the bonuses they would not have received the related Medicare reimbursement, and if the agencies increased volume, under the Medicare rules the losses simply would have increased.

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

¹⁰ See Streckfus, "Sta-Home: There's Much More to the Story," 112 Tax Notes 375 (7/24/06).

¹¹ See Rev. Rul. 59-60, 1959-1 CB 237, § 4.02(f), cited in the Fifth Circuit's opinion.

¹² Caracci 98 AFTR2d 2006-5264, 2006-5273 (CA-5, 2006).

¹³ See Bazemore v. Friday, 478 U.S. 385 (1986).

of law that there was no “net excess benefit” (a reference in part to the Service’s failure to carry the burden of proof with an appropriate valuation). In the court’s view, the legal and factual errors were so extensive that outright reversal was warranted. These errors included the Service’s reliance on an intermediate valuation to determine the amount of the assessment and the failure of the IRS to carry its burden of proof on the accuracy of the assessment. In the Fifth Circuit’s judgment, the record made it clear that the IRS would not be able to carry the burden of proof in the event of a remand.

Unanswered questions

One point of debate in the tax press has centered around the Caraccis’ motives for the conversion. On the one hand, the Caraccis’ counsel argued that Joyce Caracci and her family were concerned with maintaining a much-needed service in economically depressed rural areas—a quintessential charitable purpose.¹⁴ In fact, the Fifth Circuit noted that the Sta-home agencies were the primary home health provider in 14 of the 19 rural counties they served. Other commenters expressed a more cynical view, or at least questioned why one would voluntarily assume substantial debt and take over ownership of a business with a history of losses and zero profit potential.¹⁵ As the Caraccis’ attorney correctly observed, however, the Caraccis did not assume ownership of the assets and responsibility for the liabilities directly, but rather through S corporations that they own (and that serve to limit their individual liability).¹⁶

More to the point, however, is that the Caraccis’ situation is not at all atypical in the service industry. Many small businesspeople and professionals (e.g., physicians and lawyers) invest their own capital in businesses that year after year show no profit and pay no dividends but rather zero out net income through com-

pensation to the employees and owners working in the business. They do so as a means of making a living—i.e., their motivation is to maintain a source of wages, not investment growth. Many of those business owners also have little hope of ultimately selling their business at a profit, except perhaps to a new professional for the turnkey value of an existing business in which they, too, are in it for the wages.

Except for cases presenting a basis for arguing that compensation is unreasonable, or related to margins rather than personal effort (the disguised dividend cases),¹⁷ the corporate form is respected by the IRS and the courts under the principles outlined over 60 years ago in *Moline Properties*, 319 U.S. 436, 30 AFTR 1291 (1943).¹⁸ Short of establishing that the Caracci family was paid more than reasonable compensation, which the IRS failed to do, wanting to continue to earn a living from the operations of the home health agencies they founded hardly seems to be a purpose that should trigger the excess benefit sanctions of Section 4958.

Still, the Fifth Circuit opinion leaves at least two questions unanswered about the competing valuations. In the absence of a request for certiorari by the IRS, those questions likely will remain unanswered in this case. They may, however, inform future compliance and enforcement efforts.

The first question involves the ability to finance ongoing operations. The Caraccis argued that the conversion would improve access to capital by improving their ability to obtain bank financing or otherwise improving their access to capital for operations, an argument noted in both the Tax Court and Fifth Circuit opinions. As one commenter noted, the Caraccis would lose the benefit of charitable contributions from foundations and benevolent individuals.¹⁹ It is not clear, however, that the Sta-home entities ever actively solicited or received substantial charitable contributions. Nevertheless, it is odd at best to assert that bankers would be reluctant to loan money to nonprofit home health agencies and yet would be more willing to loan money to a for-profit home health agency with equally abysmal profit prospects. No one has yet explained how the credit risk to the bankers is any different.

The second unanswered question concerns the extent to which special circumstances that potentially impact the value of a business should be considered in Section 4958 cases. In

¹⁴ Aughtry, “Streckfus Letter Was Way, Way Off-Base,” 112 Tax Notes 449 (7/31/06).

¹⁵ Streckfus, *supra* note 10 and “Letter From Sta-Home Attorney Was Unconvincing,” 112 Tax Notes 539 (8/7/06); Nichols, “Aughtry v. Streckfus: Gentlemen ... Please,” 112 Tax Notes 883 (9/6/06).

¹⁶ Aughtry, “Sta-Home: I’ll See You at Sunrise, Mr. Streckfus,” 112 Tax Notes 707 (8/22/06).

¹⁷ See, e.g., Pediatric Surgical Associates, P.C., TCM 2001-81.

¹⁸ See also Sargent, 929 F.2d 1252, 67 AFTR2d 91-718 (CA-8, 1991) (employment tax case).

¹⁹ See Streckfus, “Sta-Home: The Angelic, the Inept, and the Argumentative,” 112 Tax Notes 805 (8/28/06).

‘COMPARABLE MEANS MORE THAN ‘SAME LINE OF BUSINESS.’



CAREFULLY WEIGH PROS AND CONS OF EXTENDING THE STATUTE OF LIMITATIONS.

Caracci, the government's expert argued that a cost-shifting opportunity for overhead expenses under the Medicare cost reimbursement system represented a value of approximately \$1.4 million. The Tax Court rejected that argument and the IRS failed to press the point on appeal. The IRS may have concluded that it was simply too complex an argument to be productive or too dependent on changing Medicare rules. In other circumstances, the IRS has taken the position that the appropriate value of a health care business is the price that would be paid by the most likely hypothetical purchaser.²⁰ In *Caracci*, that would seem to have been a hospital seeking to take advantage of the cost-shifting opportunity. The Caraccis, however, may have effectively forestalled the argument themselves by seeking out a hospital buyer before converting. In other cases where that effort is not made, the IRS could be expected to press this point. For example, the IRS has noted that the buyout of a physician partner's interest at appraised fair market value may result in inurement or private benefit if the appraisal does not take into account the impact of changes in the Stark law on future cash flows as a result of referral restrictions.²¹

Another special circumstance that failed to play into the Fifth Circuit's analysis is the effect of the apparent unavailability of a CON to open a new home health agency in Mississippi for approximately 13 years (1983-96). The Tax Court criticized the Caraccis' expert for failure to consider the value of the CON moratorium in his valuation of the Sta-home entities, marking at least the second time the Tax Court indicated that a CON has value.²² The Fifth Circuit, however, declined to attribute value to the CON as an intangible asset because it provided Sta-home with access to the same pool of patients and a money-losing business. There was no discussion by the Fifth Circuit over the value that the CON might have to a profit-making corporation pursuing a different payor mix. The S corporations were for-profit companies, and there is no indication of any binding contractual commitment for them to continue operating with the same 95%-97% Medicare patient base, even if that has been their practice.

Lessons learned

Despite the unanswered questions that linger and may be debated indefinitely, there are sev-

eral lessons in the *Caracci* saga that should inform the tax planning strategies of exempt organizations coping with the challenges of insider transactions. In some instances, state laws may add to the maze that must be navigated, but for purposes of federal tax-exemption, the Fifth Circuit's opinion provides several clear lessons in finding one's way through the thicket.

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 to seek out experienced legal and tax counsel—even if the IRS later disagrees with their 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 tax-exempt home health agency clients to convert to non-exempt status, and that most followed his advice, typically by transferring assets to newly formed 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 their new 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. For trial, they also retained an expert valuation counselor with substantial experience in valuing home health agencies. That valuation ultimately proved to be a key component in avoiding millions of dollars of excise tax liability and preserving Sta-home's exemption. As the courts noted, the taxpayers' valuations all showed that Sta-home's liabilities exceeded the value of its assets.

The Fifth Circuit's heavy reliance on the effort and experience of the Caraccis' trial expert 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

²⁰ See Kaiser, Haney, and Sullivan, "Chapter L: Integrated Delivery Systems and Joint Venture Dissolutions Update," *Exempt Organizations CPE Technical Instruction Program Textbook for FY 1995* (1994), 153.

²¹ *Id.* at 153, 177-79.

²² *Ancloite Psychiatric Center*, TCM 1998-273, *aff'd*, 190 F.3d 541, 84 AFTR2d 99-5585 (CA-11 1999) (per cur).

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. One wonders whether the IRS would have even pursued this case if the original valuations the Caraccis obtained had been as thorough. In fairness to the original experts, however, the Fifth Circuit's opinion supports the conclusion that they, too, reached the correct result in finding that the home health agencies had no positive value.

Lesson three: Economic survival of the non-profit mission is important. Prior suggestions from the IRS to the contrary notwithstanding, 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* also is a departure from the direction of prior IRS guidance. In GCM 39862, 11/21/91, analyzing the inurement and private benefit consequences of certain net revenue stream joint ventures, the IRS largely disregarded the argument that the joint ventures were essential to the survival of the non-profit. In *Caracci*, the Fifth Circuit 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. Those other companies did not have even close to the substantial Medicare patient base (and associated profit restrictions) of Sta-home, and those other companies were actually profitable (vs. Sta-home's continuing history of losses).

Lesson five: Speculative future events do not necessarily equal current value. The mere potential of future profits was not a sufficient basis for a current valuation of Sta-home. The Tax Court opinion relied heavily on the potential for profitability that the court believed could be achieved 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. Moreover, 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 tax. In *Caracci*, 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 that a final economic report had yet to be done. In the court's view, the IRS exacerbated that problem by not admitting the error until trial

EXEMPT
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OF HOME
TO HOME
SERVICES



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and then 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 the purported excess benefit (perhaps by returning the assets).²³

In the end, the Caraccis' unwillingness to extend the statute weighed in their favor 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 Service'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, and a potentially significant tax liability.

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 on 7/11/95, more than two months before legislation including Section 4958 was introduced (on 9/13/95). The conversion itself was effective 10/1/95, almost nine months before Section 4958 was finally enacted into law.²⁴ Regulations under Section 4958 were not even issued in proposed form until more than two years later.²⁵ 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 the case. The result may be somewhat different in future cases arising after the regulations were issued.

Lesson eight: Who has the burden of proof is important. A frequent question in the non-profit sector 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 process—which was discussed in Section 4958's legislative history but not incorporated into regulations until well after the Sta-home conversions—it did provide a clear illustration of the importance of the burden of proof in tax cases. In *Caracci*, errors in the Service's initial valuation shifted the burden of proof to the government to support the accuracy of the assessment, a burden that was not carried.

Next steps for the IRS and the Caraccis

At the time of this writing, no announcement had been made about any post-judgment petitions by the Caraccis (e.g., seeking attorney fees). As noted above, the IRS did not seek a rehearing before the Fifth Circuit or review by the Supreme Court. The IRS and the Solicitor General probably preferred to wait for stronger facts before going to the Supreme Court, particularly given the Fifth Circuit's withering criticism of both the Service's valuation expert and its conduct of the audit generally.

Conclusion

In the wake of the *Caracci* decision, and with increasing emphasis on (and Congressional pressure for) IRS enforcement of the excess benefit rules, the time may be ripe for exempt organizations to analyze a variety of transactions for potential excess benefit implications, and where necessary pursue corrective action and disclosures to the IRS. State Attorneys General are also increasingly active and interested in matters of nonprofit compensation and benefits, as evidenced by recently proposed rules for executive compensation in the nonprofit charitable sector in Ohio,²⁶ the investigations of various health care organizations by Attorney General Mike Hatch in Minnesota,²⁷ and the recent investigation of the J. Paul Getty Trust by Attorney General Bill Lockyer in California.²⁸ Tax-exempt organizations of all types therefore need to take to heart the lessons of the *Caracci* case when considering any transactions that may implicate Section 4958. ■

²³ Correction may be made by return of specific property if approved by the exempt organization without the disqualified person participating in the decision, though the disqualified person also may owe interest and must cover any decline in value of the property. 26 C.F.R. 53.4958-7(b)(4), (c).

²⁴ P.L. 104-168, 7/30/96.

²⁵ REG-246256-96, 1998-2 CB 224.

²⁶ Detailed proposed rules issued 6/29/06 were subsequently replaced with a scaled down version providing for formation of an advisory council to explore governance improvements and model policies. Ohio Admin. Code 109:1-1-10 (Proposed 9/6/06).

²⁷ See "Health Care: Making the Best of a Bad Bargain" (Minn. AG), available online at <http://www.ag.state.mn.us/consumer/PDF/PR/HealthCareMakingReportText.pdf>.

²⁸ See "Report on the Office of the Attorney General's Investigation of the J. Paul Getty Trust" (Cal. AG), available online at http://ag.ca.gov/newsalerts/cms06/06-085_0a.pdf?PHPSESSID=cdeb747f293ec37d290dc1c235ebe29.