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Protecting Tax-Exempt Status: The Importance of Intangible Asset Valuation

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Purpose

- Explain the consequences of entering into transactions without properly valuing all organization assets
- Explain the types of asset valuation relating to transactions commonly scrutinized by the IRS

Potential Tax Consequences Resulting from Failure to Properly Value Assets

Potential Consequences

- Tax-Exemption issues
  - Private inurement
  - Impermissible private benefit

- Intermediate Sanctions

Exemption Issues

- Private Inurement
  - Code generally provides that no part of organization's net earnings can inure to the benefit of any private individual or shareholder
  - Applies to organizations exempt under multiple sections of the Code, including but not limited to: 501(c)(3), 501(c)(4), 501(c)(6), and 501(c)(7)
- Impermissible Private Benefit

Exemption Issues

- Impermissible Private Benefit
  - Generally, tax-exempt organizations are required to limit their activities to those that further their stated mission
  - A non-exempt purpose is generally a purpose that serves a private rather than a public benefit, as such is generally called a "private benefit"
  - Provision of an impermissible private benefit is grounds for revocation
  - The private benefit prohibition is imposed on a more limited group of exempt organizations than private inurement, and may not be applicable to organizations exempt under 501(c)(6) or 501(c)(7)

Intermediate Sanctions

- Internal Revenue Code ("Code") section 4958 allows the Internal Revenue Service ("Service") to impose penalties on "disqualified persons" who participate in or approve "excess benefit transactions"
- These penalties are commonly referred to as the intermediate sanctions
- Similar to "private inurement" concept

Intermediate Sanctions – Penalties

- Penalty for receipt of an excessive benefit:
  - Return the value of the excessive benefit to the organization; and
  - An excise tax of either:
    - 25% of the value of the excessive benefit if the benefit is returned to the organization prior to the issuance of a notice of deficiency by the Service, or
    - 200% of the value of the excessive benefit if the benefit is returned after the Service issues the notice of deficiency

Intermediate Sanctions – Penalties

- Penalty on organization managers for approval of an excessive benefit transaction:
  - Section 4958(a)(2) imposes a 10% tax on any organization manager that knowingly approves an excess benefit transaction

Why Valuations Are *EXTREMELY* Important

IRS Enforcement – Recent Litigation

- Reason for Transaction
  - Organization was a tax-exempt educational counseling organization
  - CEO’s wife was the majority owner of a business that provided back-end services related to the organization’s counseling program
  - Largest donor decided to withhold all contributions until the organization dissolved the contractual relationship with back-end service provider
  - Organization decided that it could not continue to exist without the continued support of its largest donor

IRS Enforcement – Recent Litigation

- Facts Regarding Transaction
  - The time remaining on contract between the organization and Service provider was three years
  - The cost of breaching was estimated to be $2.2 million
  - At the time of the transaction, wife owed $600,000 from the purchase of the company
  - Without obtaining a formal valuation, wife agreed to sell the service provider to the organization for the amount that she owed to prevent a personal loss and ensure the organization's continued existence

IRS Enforcement – Recent Litigation

- IRS Position
  - The value of agreement was $0 because wife would not have sued an organization managed by her husband
  - Value of all assets, tangible and intangible, was $15,000 (the amount listed in the contract)
  - Wife received an excess benefit of $585,000
  - IRS issued a deficiency notice for $1.3 million, plus interest
  - IRS internal expert valuation

IRS Enforcement – Recent Litigation

- Facts During Litigation
  - Organization paid for two independent valuation reports, both demonstrated that the value of the company was in excess of $800,000
  - IRS internal expert determined that value was in excess of $700,000
  - IRS refused to consider the report of any expert and continued to assert that the value was $0

IRS Enforcement – Recent Litigation

- Results
  - After almost two years of litigation, the IRS settled the case by fully conceding the deficiency
  - The taxpayer was not required to pay any amount of taxes or penalties, but paid hundreds of thousands of dollars in legal fees
- Lessons
  - A valuation before the transaction could have prevented a lot of stress and saved a lot of money

Common Transactions Involving Intangible Assets

Common Intangible Asset Transactions

- The sale of a membership list by an exempt organization to a taxable entity
- An exempt organization's licensing of its trademark or logo by a taxable entity
- The sale or license of software either from an exempt organization to a taxable entity (and vice versa)

Questions and Discussion

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