The Tax Court Decides the Opening Skirmish in Intermediate Sanctions Litigation

An opinion focused on valuation also sets a marker for whether revocation should be imposed as well.

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Over six years ago, President Clinton signed the Taxpayer Bill of Rights 2 into law. Among its many provisions was the most significant piece of legislation for Section 501(c)(3) and 501(c)(4) organizations in decades—Section 4958, which imposed an excise tax on insiders who receive excessive economic benefits from such organizations. Known as intermediate sanctions because it allowed the IRS for the first time to penalize such transactions with something short of revocation, this new tax caused many charitable and social welfare organizations to wonder exactly how the Service would choose to use this new tool.

Reflecting a respect for the power granted by Section 4958, the Service has carefully controlled its use, with any cases involving intermediate sanctions being coordinated by the IRS National Office.1 It is therefore not surprising to see that the first court battle over their application has involved a seven-figure excess benefit amount and transactions involving all the assets of three charitable organizations. It will also not be surprising to observers who have been following this area that the case ultimately turned on expert testimony regarding whether the transactions at issue granted an excess benefit to the organizations' insiders. Beyond the intricacies of competing valuation opinions, however, this case is also important because it begins to draw the boundaries for when intermediate sanctions is the only appropriate penalty and when revocation of the tax-exempt status of the charity involved is also justified. The case also provides compelling evidence for the importance of intermediate sanctions; absent the existence of intermediate sanctions, there would have been no effective remedy at the federal level to address what the court found to be a serious violation of the Section 501(c)(3) prohibition on private inurement.
Consolidated under the name Michael T. Caracci and Cindy W. Caracci, 118 TC No. 25 (5/22/02), the case involved the transfer of the entire assets of three charities to three corresponding for-profit entities owned and controlled by insiders of the charities. The petitioners included the individual insiders, their family members, and the for-profit companies. The petitioners also included the charities themselves, as the Service had proposed not only to impose intermediate sanctions on the insiders but also to revoke the tax-exempt status of each of the participating charities.

The factual background

The various participants in the transactions are shown in Exhibit I, above. Of the eight Caracci family members involved, six of them worked for the three Section 501(c)(3) organizations (the "Sta-Home EOs") and the corresponding for-profit S corporations (the "Sta-Home for-profits") in the capacities listed next to their names in Exhibit I. The three Sta-Home for-profits were and are owned by the parents, Victor and Joyce Caracci, and their three adult children in the following proportions: Victor Caracci (17.5%), Joyce Caracci (17.5%), Christine McQuillen, born Christine Caracci (17.5%), Michael Caracci (30%) and Vincent Caracci (17.5%). Members of the Caracci family have also been the only directors and officers of the Sta-Home for-profits.

In 1976, Vincent and Joyce Caracci, along with a third individual not involved in the case, founded the first of the Section 501(c)(3) organizations, Sta-Home Home Health Agency, Inc. In 1977 they founded the other two Sta-Home EOs. In the initial years of operation, the Caraccis borrowed money collateralized by their residence to fund the Sta-Home EOs and guaranteed the extension of credit to the charities. As of 1995, when the transactions occurred, the three directors of each Sta-Home EO were Joyce Caracci, Michael Caracci and Christina McQuillen.

The Sta-Home EOs provided home health care services under certificates of need (CONs) issued by the state of Mississippi.2 CONs are required to operate a licensed home health agency under Mississippi law, and Mississippi has had a moratorium on the issuance of new CONs for such activities since 1983. Michael Caracci was active in efforts to prevent the Mississippi legislature from lifting this moratorium. The only way to obtain such a CON in 1995 was therefore to purchase the CON of an existing home health care agency.

During 1995, over 95% of the services provided by the Sta-Home EOs, which included 834,596 home health care visits to over 8,000 patients, were provided to Medicare beneficiaries. Medicare, a government program established by the federal Social Security Act, is the principal health care insurance for individuals who are either disabled or aged 65 or older. In 1995, Medicare reimbursement to home health care providers was the lesser of (1) their actual reasonable costs or (2) customary charges, subject to a “cost cap” based on the aggregate per-visit cost limitation under the law. Medicare made the reimbursements through periodic interim payments (PIPs) to home health care agencies every two weeks. PIPs were then reconciled with quarterly and annual reports filed by the agencies with a fiscal intermediary (e.g., an insurance company). If the PIPs differed in amount from the costs reported, after any disallowances, the fiscal intermediary either reimbursed the agency any underpayment or required the agency to repay any overpayment. For the Sta-Home EOs, the disallowance rate was 0.7% in 1995.

Because the Medicare reimbursement system was limited to reimbursing actual costs, subject to various limits and disallowances, organizations relying on Medicare reimbursements for virtually all of their income had no ability to realize profits beyond costs. In effect, any disallowance or denied claim produced a loss in terms of cash flow. The Sta-Home EOs followed this pattern, showing increasing revenues, from $27 million to $45 million, but also increasing losses, from $173,000 to $507,000, in each of the three fiscal years preceding 10/1/95 (the Sta-Home EOs’ fiscal years ended on September 30). Further financial details are provided in the valuation discussion, below.

In 1995, the Sta-Home EOs had a generally good reputation in Mississippi and ranked first or second in market share in 14 of the 19 counties in their service area. In 1993, they become the first freestanding agencies in Mississippi to become accredited by the Joint Commission on Accreditation of Healthcare Organizations (JCAHO). JCAHO is a national nonprofit organization that evaluates and accredits more than 17,000 health care organizations and programs in the US.

The conversions. In 1994, the Caracci family became aware of a proposed shift in Medicare's reimbursements policy to a prospective payment system. Under that system, the Sta-Home EOs would no longer receive a reimbursement check every two weeks. They would instead have to file a claim for every service rendered and to wait for the claim to be processed before being reimbursed. The Caracci family and the Sta-Home EOs believed this change could create a cash flow problem for the Sta-Home EOs and also reduce the EOs' income. They therefore consulted Thomas Kirkland, an attorney who had advised a number of home health care agencies about converting from nonprofit to for-profit status, in late 1994. He recommended conversions for the Sta-Home EOs, in part because various bankers had told him that they would be reluctant to lend money to nonprofit home health care agencies. The regular accountant for the Sta-Home EOs, Danny Hart, agreed with this recommendation, so the Caraccis decided to proceed with the conversions.

Kirkland retained a tax attorney, James Pettis, to assist with the conversions. Apparently at Pettis' insistence, Kirkland's firm then retained Hart's accounting firm to appraise the assets of the Sta-Home EOs as of the proposed transaction date of 10/1/95. Kirkland's firm had not obtained an appraisal for any of its other conversions.
Pettis reviewed the first appraisal from Hart's firm and was concerned that it both failed to deal with issues relating to intangible assets and did not meet the IRS standard for valuations provided in Rev. Rul 59-60, 1959-1 CB 237. He therefore requested that Hart's firm produce a second appraisal. Some of Pettis' concerns remained after reviewing the second appraisal, so he sought and received assurance that the liabilities of the Sta-Home EOs far exceeded the value of their assets. Hart's firm issued a final appraisal on 8/28/95.

On 7/11/95, the board of directors of the Sta-Home EOs authorized the conversions. On 9/1/95, the Sta-Home EOs filed "Notices of Intent to Change Ownership" with the Mississippi Department of Health. On 10/19/95, a partner at Hart's firm sent a letter to Kirkland setting out several business reasons for proceeding with the conversions. On 10/23/95, documents were executed transferring, effective 10/1/95, all of the assets of the Sta-Home EOs to the corresponding Sta-Home for-profits, as shown in Exhibit I. The only consideration for the transfers was the assumption by the Sta-Home for-profits of the liabilities of the Sta-Home EOs.

The operations, employees, and assets of the Sta-Home for-profits have remained essentially identical to those of the Sta-Home EOs. The Caracci family members also have remained in the same positions with the Sta-Home for-profits as they held with the Sta-Home EOs. The Sta-Home EOs ceased all activities immediately after the conversations and have been dormant since that time.

The IRS position. The IRS asserted in its notices of deficiency that the collective assets of the Sta-Home EOs had a fair market value of $18,543,694 in excess of the liabilities assumed by the Sta-Home for-profits. The IRS therefore asserted that Victor and Joyce Caracci and their three adult children—Michael Caracci, Vincent Caracci, and Christina McQuillen—were jointly liable for Section 4958 first-tier taxes equal to 25% of the alleged excess benefit, or $4,635,923. It also asserted that the three Sta-Home for-profits were each liable, jointly with the five Caracci family members, for a share of that amount, depending on the alleged fair market value of the assets each Sta-Home for-profit received, and that each of these persons was liable for the Section 4958 second-tier taxes that totaled $37,087,388. The IRS initially asserted that Joyce Caracci, Michael Caracci, and Christina McQuillen were jointly liable for the Section 4958 first-tier manager's tax in the amount of $30,000 ($10,000 per transaction), but the IRS withdrew this assertion.

The IRS also revoked the tax-exempt status of the three Sta-Home EOs because of their participation in the transactions, and asserted income tax deficiencies against the three adult children and their spouses. The IRS apparently based the income tax deficiencies on the theory that the parents, Victor and Joyce Caracci, somehow "owned" the Sta-Home EOs and constructively transferred the assets of those entities to their three adult children, who then contributed those assets to the Sta-Home for-profits in exchange for their ownership shares of the Sta-Home for-profits. These transfers therefore resulted in income to those children and their spouses, with whom they filed joint returns, under Section 61 because the transfers represented accessions of wealth. The IRS also initially asserted the 20% Section 6662(a) accuracy-related penalty in connection with these income tax liabilities, but withdraw this assertion.

The valuations

According to unaudited financial statements prepared by Hart's firm, the Sta-Home EOs had combined financial statements for the fiscal years ending 9/30/95 as shown in Exhibit II, above.

To facilitate their cash flows, the Sta-Home EOs required their employees (including the Caracci family members) to forgo being paid for the first six weeks of their employment, at the end of which period they received a paycheck for two weeks of work. The Sta-Home EOs withheld the remaining four weeks of wages until the employees left the company. The liabilities given in Exhibit II reflect these withheld wages, which were recorded as accrued payroll and totaled $4.1 million as of 9/30/95. The liabilities for these withheld wages were included in the liabilities transferred to the Sta-Home for-profits as part of the conversions.

The Sta-Home EOs paid annual discretionary bonuses to all their employees except new hires. For the pay period ending 12/12/94, those bonuses totaled $966,204. In 1995, the Sta-Home EOs approved several bonuses, including bonuses of $664,116 on June 23, and $2,314,086 on September 29. The September 29th bonus was not paid immediately and so created a liability that was assumed by the Sta-Home for-profits as part of the conversions.

State of the industry. According to the court's opinion, the home health care industry grew significantly in the 1990's. National expenditures for home nursing care grew from $3.8 billion in 1990 to $20.5 billion in 1997. There were also many acquisitions in the industry, including 42 in 1994, 60 in 1995, 112 in 1996, and 139 in 1997. In Mississippi, the state Board of Health identified 11 home health care agency acquisitions in 1994 and 1995; seven by hospitals, two by home health care agencies, one by an individual from a bankruptcy trustee, and one in a corporate reorganization. At least one acquisition involved a non-Mississippi entity as the acquirer.

The acquisitions were driven in large part because the buyers—primarily hospitals, nursing homes, and other home health agencies—could shift a portion of their costs to the acquired home health care activities, thereby allowing the buyer to be reimbursed for those costs by Medicare. This cost-shifting was available because the acquired home health care agencies were currently claiming less than the cost cap on Medicare reimbursements and because Medicare reimbursed for overhead as well as for direct costs. The Sta-Home EOs had historically received reimbursements of 5% below the cost cap, according to a statement made to the Commissioner's expert witness, but that amount had shrunk to 2.86% in the most recent year before the conversions. This cost-shifting capacity was also threatened by the proposed shift to a prospective payment system. This shift did eventually occur, but not until 9/30/99, when legislation passed by Congress in 1997 took effect.

General valuation methods. There are three basic approaches for valuing closely held business interests, whether owned by a nonprofit or a for-profit entity. The approaches are generally known as the asset-based approach, the income approach, and the market approach.3

The asset-based approach, also know as the cost approach, involves valuing the assets of the subject company. One common asset-based approach method is the asset accumulation method, which involves valuing the individual assets of the subject company. These assets include current assets (cash, marketable securities, receivables, inventory, etc.), tangible personal property, real estate, discrete intangible assets (patient relationships, favorable contracts, leasehold interests, a trained and assembled workforce, etc.), and goodwill. The values of the individual assets are then totaled to estimate the fair market value of all of the assets of the company.

The income approach is based on determining the present value of the future economic income to be derived from a company. The yield capitalization method is one common method under the income approach, and often involves using a discounted cash flow analysis. This analysis requires projecting the cash flow from the business based on projections of the revenue, expenses, investments, and capital structure of the company, and then discounting the resulting cash flows using an appropriate discount rate to arrive at a present value for the cash flows. That present value provides an estimate of the value of the subject company.

The market approach is based on identifying comparable companies and calculating various multiples based on those comparable companies, such as a price-to-earnings multiple, price-to-dividends multiple, and price-to-assets multiple, among others. Those multiples are then adjusted according to how the subject company compares to the comparable companies, and applied to the subject company to determine its price (i.e., the value of its assets). The resulting figures may also be adjusted to reflect a minority interest discount, a control premium, or similar factors. Two common methods under this approach are the guideline publicly traded company method, under which the comparable companies are publicly traded companies, the prices of which are readily available, and the guideline merged and acquired company method, under which the comparable companies are companies that have recently been bought or sold.

All of these methods can be used to determine the value of a company's assets or net assets. For example, under the asset-based approach, the liabilities of the subject company can also be evaluated. The experts who testified, and the court, generally determined the value of the assets of the Sta-Home EOs first, then compared the value of those assets to the liabilities of the Sta-Home EOs, which liabilities were assumed by the Sta-Home for-profits. The discussion below follows this pattern in describing the various valuations. Since the only consideration provided by the Sta-Home for-profits for the assets of the Sta-Home EOs was the assumption of these liabilities, the conversions would result in the Sta-Home for-profits receiving an excess benefit if the value of those assets exceeded the liabilities. The results of the various valuations, including the court's, are summarized in Exhibit III, above.

Petitioners' expert. The petitioners relied on Allen D. Hahn, a director in PricewaterhouseCoopers Northeast Region Corporate Valuation Consulting Group, as their expert witness. Hahn based his conclusions primarily on the asset-based approach, using the "adjusted balance sheet" method. This method involves restating the business' accounting balance sheet to determine the company's fair market value, including adding any assets that may be missing from the accounting balance sheets. Hahn rejected the income approach as inapplicable because the Medicare reimbursement structure resulted in little if any profits by home health care agencies, so there would be no net cash flow stream to value. He also used the market approach, but only to corroborate the value he obtained using the adjusted balance sheet method.

Asset-based approach. Hahn prepared two different scenarios, a "best case" and a "base case," for adjusting the combined balance sheet of the Sta-Home EOs to compensate for the difficulty in obtaining complete data for a period that was more than five years in the past. He adjusted the assets of the Sta-Home EOs by decreasing accounts receivable, estimated settlements from Medicare, and the allowances for bad debts and unsuccessful claims, while increasing the allowance for contractual adjustments. He also added two intangible assets to the balance sheet, the workforce in place (valued at $2,100,000) and, in the best case scenario only, the value of the cost-shifting capacity of the businesses to a potential acquirer (valued at $667,467). The results of these adjustments were asset values of $11,757,459 and $10,521,977 under the best case and base case scenarios, respectively.

Hahn then compared these asset values to the liabilities, after increasing the liabilities by $201,000 to reflect amounts he concluded would be due to Medicare and, in the base case scenario only, by $517,909 to reflect reimbursement adjustments he expected when pending costs reports were audited by the fiscal intermediary. The resulting liabilities were $12,345,655 and $12,863,564 under the best case and base case scenarios, respectively. This resulted in the liabilities exceeding the value of the assets by $588,196 and $2,341,587, respectively, for the Sta-Home EOs.

Market approach. Applying the market approach, Hahn selected 13 "traditional" visiting nurse companies, similar to the Sta-Home EOs in that they did not offer more lucrative home health care services, such as infusion and respiratory services. Eight of the 13 guideline companies had operated at a loss in the prior year and seven of them had negative equity capital. Using these guideline companies, he calculated two multiples that he compared to the Sta-Home conversions: sales price to most current revenues and sales price to total book assets. The medians for these two multiples were 0.68 and 1.90, respectively. Using the asset value determined under the best case scenario, Hahn found that the Sta-Home EOs fell within the range of the multiples for his guideline companies, although second to last for both ratios. The Sta-Home EOs had a 0.26 sales price (i.e., asset value)-to-revenues multiple, slightly above the 0.22 multiple for the lowest guideline company, Housecall, Inc., and a 1.1 sales price-to-total book assets multiple, slightly above the 1.08 multiple for the lowest guideline company, Clasen Health Services.4

Hahn concluded that the guideline company data confirmed the asset value of the Sta-Home EOs based on their adjusted balance sheets and so, rounding the figures from his first analysis, he stated that the Sta-Home EOs had liabilities in excess of the value of their assets of between $600,000 and $2,350,000 at the time of the conversions. Hahn considered, but decided against, adjusting this conclusion to reflect a premium for control because the methods he had used already assumed a transfer of all of the assets of the Sta-Home EOs. He also chose not to adjust his conclusion to reflect a minority discount because the businesses were running a loss.

Respondent's expert. The Commissioner relied upon Charles A. Wilhoite, a certified public accountant, principal of Willamette Management Associates, and co-director of that firm's office in Portland, Oregon. Wilhoite used the market approach and the income approach. He rejected the cost approach as being too unreliable given the importance of the value of the many intangible assets owned by the Sta-Home EOs (including operating licenses, Medicare certifications, patient lists, referral relationships, a trained and assembled workforce, proprietary policies and procedures and trade name, going concern value, and the CONs) and the unavailability of sufficient information to accurately value those assets.

Market approach. For the market approach, Wilhoite used both the guideline publicly traded company method and the guideline merged and acquired company method to determine the "revenue pricing multiple." The revenue pricing multiple is the ratio of the market value of investment capital (MVIC) to annual revenues. MVIC reflects the capital structure of a company, and is equal in value to the ownership equity plus long-term debt. The relationship of MVIC to the value of the assets of a company is shown by the following formula:

Value of Assets = MVIC + Current Liabilities

Using the guideline publicly traded company method, Wilhoite determined the revenue pricing multiple by looking at seven publicly traded companies that operated home health care agencies. This median multiple was 0.61, but because nonprofit companies have a considerably lower return on capital, he discounted this amount by 50% to 0.30. Applying this discounted ratio to the 1995 annual revenues of $45,209,000 resulted in an MVIC of approximately $13,563,000.

Using the guideline merged and acquired company method, he looked at information about actual mergers and acquisitions as reported in the "Home Health Care M&A Report" published by Irving Levin Associates, Inc. He identified over 60 comparables, including one that operated at a loss and had a revenue pricing multiple of 0.21. The median multiple was 0.50. Based on this information, he concluded that the appropriate multiple was 0.25—20% higher than the multiple for the loss-generating comparable but 50% lower than the median multiple. Applying this multiple to the 1995 annual revenues resulted in an MVIC of approximately $11,302,000.

Income approach. For the income method, Wilhoite estimated that an acquirer could have saved $1,408,168 in 1995, based on the fact that the Sta-Home EOs had historically received reimbursements 5% below the Medicare cost cap. Using a weighted average cost of capital for the Sta-Home EOs, less the anticipated increases generated by long-term growth, Wilhoite discounted this savings stream by 12.8% to reach a MVIC of $11,001,000.

Weighted average. Wilhoite then weighed and combined the three results, giving the most weight (50%) to the income approach value and the least weight (20%) to the guideline publicly traded company method. He concluded that the best estimate of the MVIC for the Sta-Home EOs was $11,604,000. To determine the value of the Sta-Home EOs assets, he made two adjustments to this figure. First, he decreased it by $2,020,000 to reflect the amount by which current liabilities exceeded current assets, which he concluded an acquirer would have to fund almost immediately as a working capital infusion. Second, he added current liabilities of $11,274,000. The resulting total asset value for the Sta-Home EOs was therefore $20,858,000. Comparing this figure to the liabilities of Sta-Home EOs reported on the audited 1995 financial statement—$13,310,860—leads to the conclusion that the value of the assets exceeded the liabilities by $7,547,140, according to Wilhoite's analysis.

The court's opinion
After summarizing the facts, the court turned to the critical issue of the fair market value of the assets transferred from the Sta-Home EOs to the Sta-Home for-profits.

Fair market value. The court began by reciting the basic legal framework:
Value and valuation. The determination of fair market value is a factual determination based on all of the relevant evidence and appropriate inferences from that evidence.5

- Fair market value is the price that a willing buyer would pay a willing seller, both persons having reasonable knowledge of the facts and neither person being under any compulsion to buy or sell.6
- The willing buyer and willing seller are hypothetical persons who are presumed to be dedicated to achieving the maximum economic advantage, and the characteristics of these hypothetical persons are not necessarily the same as the personal characteristics of the actual seller or a particular buyer.7
- Fair market value reflects the highest and best use of the relevant property on the valuation date, including special uses that are realistically available because of the property's adaptability to a particular business, regardless of whether the owner has actually put the property to its highest and best use.8

The court also reviewed the legal framework for admitting and assessing expert testimony:

- A trial judge is responsible for ensuring that any and all expert testimony is relevant and reliable.9

• A trial judge has broad discretion to evaluate the cogency of an expert's analysis, and decide whether that analysis is helpful for resolving the case before the court, and what portions, if any, of that analysis are useful.10
• A trial judge is not bound by any expert's opinion and will reject an expert's opinion to the extent it is contrary to the judgment he or she forms on the basis of his or her understanding of the record as a whole.11

The court accepted the qualifications of both Hahn and Wilhoite to serve as experts. Hahn had written extensively on the valuation of home health care agencies (which came back to haunt him, as detailed below) and frequently appeared as an expert witness. Although the petitioners challenged Wilhoite's qualifications, the court rejected this challenge as "nonsensical and border[ing] on the frivolous," noting his extensive experience with valuing professional practices, particularly in the health care field.

Rejected approaches and arguments. The court first addressed the petitioners' argument that common sense required a decision in their favor because the transferred businesses lost money and had liabilities that exceeded their assets. The court rejected this argument for several reasons. For one, it concluded that a company with a negative book value may still have a fair market value greater than zero. In addition, operating at a loss does not necessarily mean that a company's intangible assets (which were not reflected on the balance sheets of the Sta-Home EOs) had no value, particularly given that the businesses were clearly capable of generating substantial revenue. Finally, the expenses and liabilities of the Sta-Home EOs before the conversions were increased by two items (1) the September 1995 employee bonus of over $2.3 million, absent which the Sta-Home EOs would have both realized positive net income for the 1995 fiscal year and had a positive net worth as of the end of that year, and (2) the high level of compensation (80.5%) as a percentage of operating expenses when compared to industry averages (70%-75%).

The court then reviewed the various approaches and methods employed by the two experts, Hahn and Wilhoite. It rejected Hahn's analysis in its entirety. With respect to his adjusted balance sheet approach, the court found that Hahn failed to take sufficient account of the value of the Sta-Home EOs' intangible assets. particularly the following:
• ***Workforce in place.*** Hahn assigned a value of $2.1 million to the "workforce in place," but the court found this value to be low given that the workforce represented approximately 1,000 employees, many of them highly trained professionals, consisting of 25% of the full-time health care staff and 17% of the part-time staff in the entire state of Mississippi. The court was also troubled by the fact that Hahn used the same value for this intangible in both his "best case" and his "base case" scenarios.
• ***Cost-shifting capacity.*** The court also felt that Hahn undervalued the value of the cost-shifting capacity of the businesses. Hahn attributed value to this capacity only in his "best case" scenario and then only $667,000, based on his assumption that this capacity would last for no longer than a year because of likely changes in the Medicare reimbursement structure. The court felt that the shift in the Medicare reimbursement structure, while a real possibility, was far from that certain, so at least a two-year life should have been given to the capacity.

- ***Certificates of need.*** The court was troubled by Hahn's failure to place any value on the Certificates of Need held by the Sta-Home EOs, even though Michael Caracci had felt the CON moratorium valuable enough to lobby to preserve it.
- ***Overall ratio.*** The court noted that Hahn's value for the intangible assets represented only 17.68% of total assets, while a 1998 article he had authored showed the goodwill value of seven publicly traded home health care companies as ranging between 22% and 56% of total asset value.

The court also found Hahn's use of the market approach to be unconvincing for three reasons. First, while the Sta-Home EOs fell within the range of the ratios for the guideline companies by virtue of being the second lowest in each category, the lowest-ranked sales price-to-revenues multiple company, Housecall, Inc., had a sales price to total book assets multiple of 1.64, much higher than the Sta-Home EOs multiple of 1.1 under Hahn's "best case" scenario. Applying this 1.64 multiple to the Sta-Home EOs total book assets of $10,736,407 would have resulted in a sales price of approximately $18 million.

Similarly, the lowest-ranked sale price-to-total book assets multiple company, Clasen Health Services, had a sales price to revenues multiple of 0.74, as compared to 0.26 for the Sta-Home EOs under Hahn's best case scenario. Using a 0.74 multiple on the 1995 revenues of $45,209,000 would have resulted in a sales price of approximately $33 million.

Finally, Hahn had authored a 1997 article stating that a standard market benchmark for valuing traditional visiting nursing agencies was a sales price to revenues multiple of 0.55, well above the 0.26 for the Sta-Home EOs based on his best case scenario.
The court rejected Wilhoite's income approach as too speculative, since it relied solely on a single income stream (from the cost-shifting), did not take into account the possible change in the Medicare reimbursement structure, and relied on the historical cost-shifting capacity of 5% rather than the value for the most recent year of less than 3%.

The court also rejected three arguments by petitioners. First, petitioners argued that it was inappropriate to consider the value of the cost-shifting capacity. The court concluded, however, that a hypothetical buyer would grant value to the cost-shifting capacity. It apparently based this conclusion on the fact that many if not most buyers would be able to use the capacity, that both experts had assigned value to this capacity, and that Hahn had stated in a 1998 article that transaction prices generally reflected this capacity. Petitioners also argued that the poverty and rural conditions existing in Mississippi required a substantial downward adjustment, but the court said that these conditions were offset by the fact that the federal average per-patient Medicare payment of $13,432 in Mississippi was higher than in any other state. Finally, petitioners argued that there was no market in Mississippi for home health care agencies, but the court concluded that the record revealed many contemporaneous sales in Mississippi.

Accepted approach. Having considered the various approaches used by the two experts, the court concluded that the market approach was the best, and Wilhoite's market analysis was the most sound. It adjusted Wilhoite's analysis, however, to take into account the fact that the Sta-Home EOs did not provide the most remunerative home health care techniques, such as infusion and respiratory therapies. To reflect this fact, it reduced the guideline publicly traded company method ratio from the already discounted 0.30 to 0.25, or the same ratio that Wilhoite had concluded emerged from the guideline merged and acquired company method. Applying this 0.25 revenue multiple resulted in an MVIC of approximately $11,300,000.

The court also concluded that an adjustment was needed to Wilhoite's computation of the value of the Sta-Home EOs' assets. It noted that the $4.1 million in liabilities that represented the four weeks of pay withheld from every employee at the start of their employment was the equivalent of long-term debt and, as such, was already reflected in the MVIC amount. Removing that amount from the current liabilities figure of $11,475,000 reduced the current liabilities to $7,375,000, but also eliminated the need to adjust for a working capital infusion because now the current assets exceeded the current liabilities, so no such infusion was required. Adding the reduced current liabilities to the revised MVIC led to a value for the Sta-Home EOs' assets of $18,675,000. The court noted that this asset value figure resulted in a sales price-to-revenue multiple of 0.42, lower than the 0.68 median of Hahn's guideline companies, and a sales price-to-total book assets multiple of 1.75, less than the 1.90 median of Hahn's guideline companies.

Assumed liabilities. The consideration provided by the Sta-Home for-profits for the assets of the Sta-Home EOs was the assumption of the liabilities of the Sta-Home EOs. The court concluded that these liabilities equaled the liabilities reported on the audited balance sheet of the Sta-Home EOs,12 or approximately $13,310,000, plus the Medicare disallowance reserve account determined by Hahn to equal $201,000. Subtracting these liabilities from the value of the assets resulted in the Sta-Home for-profits receiving an excess benefit of $5,164,000.

Application of Section 4958 Taxes. Section 4958 imposes two tiers of taxes. The first tier is a tax equal to 25% of the excess benefit on the insider, or "disqualified person," who receives the excess benefit.13 The second tier is a 200% tax on the disqualified person; the second-tier tax applies only if the disqualified person has not "corrected" the excess benefit transaction within the "taxable period."14 "Corrected" means undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the tax-exempt organization in a financial position not worse than that in which it would be if the disqualified persons were dealing under the highest fiduciary standards.15 The taxable period runs until from the date of the transaction until the earlier of the date when the notice of deficiency for the first-tier tax is mailed or the first tier tax is assessed.16 Section 4958 also imposes a 10% tax on managers, capped at $10,000 per excess benefit transaction, but only if they knowingly, willfully and without reasonable cause approve an excess benefit transaction.17

The two taxes on disqualified persons can be abated. The first-tier tax will be abated if the Secretary is satisfied that the taxable event was due to reasonable cause, not willful neglect, and the event is corrected within the "correction period."18 The correction period ends 90 days after the mailing of a notice deficiency, but is extended by any period during which a deficiency cannot be assessed because of the pendency of a Tax Court case.19 A Tax Court decision is not final, and the Tax Court case therefore remains pending, until either the time for appeal has expired without a notice of appeal being filed or the appeal, including the resolution of any petition for certiorari, has been decided.20 The second-tier tax will be abated if the event is corrected within the correction period, and there is no requirement that the event be due to reasonable cause and not willful neglect.21

Applying Section 4958, the court concluded that Victor and Joyce Caracci and their three adult children were jointly liable for both the first- and second-tier taxes, based on a total excess benefit of $5,164,000. The court also allocated the same taxes to the Sta-Home for-profits, based on their ratio of the 1995 revenues of their respective tax-exempt predecessors. The court declined to apply any type of minority discount to the excess benefit amount since the Sta-Home EOs transferred all of their assets to the Sta-Home for-profits.

Petitioners argued for abatement of the first- and second-tier taxes. While the court noted that abatement is allowed, it concluded that because the petitioners had not yet corrected the excess benefit transactions, and the correction period had not yet ended, it would have been premature to decide this issue.

Revocation. One of the qualifications for tax-exempt status under Section 501(c)(3) is that "no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual."22 The term "private shareholder or individual" refers to persons having a personal and private interest in the activities of the organization.23 A Section 501(c)(3) organization also must not be operated for the benefit or private interests such as designated individuals, the creator, the creator's family, shareholders of the organization, or persons controlled directly or indirectly by such private interests.24 The court specifically noted that when a Section 501(c)(3) organization sells its assets for less than fair market value to a for-profit corporation that has, as its shareholders, directors of the tax-exempt entity, the sale constitutes inurement and revocation may be appropriate.25

The court also noted that the legislative history for the intermediate sanctions specifically addressed how the enactment of Section 4958 would affect the applicability of revocation. Congress intended that the IRS be able to impose intermediate sanctions in addition to or in lieu of revocation.26 The legislative history also provides, however, that "[i]n general, the intermediate sanctions are the sole sanction imposed in those cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization."27
Relying on this legislative history, the court reversed the IRS revocation of the tax-exempt status of the Sta-Home EOs for three reasons. First, it found that each tax-exempt entity had engaged in only a single excess benefit transaction, a transaction that was adequately addressed by the imposition of intermediate sanctions. Second, it found that the Sta-Home EOs had not engaged in any activities or been operated contrary to their tax-exempt purpose; they had in fact been dormant since the transfers. Third, the court found that the continued tax-exempt status of the Sta-Home EOs would facilitate the correction of the excess benefit transactions.

Income taxes. The court concluded that whatever accession of wealth the Caracci adult children may have received constituted gifts and therefore fell within the Section 102(a) exemption of gifts from gross income. It therefore found that the Caraccis did not owe any income tax as a result of the conversions.

Lessons to be learned
Like any skirmish, this first one over the intermediate sanctions offers guidance for those who will be involved in disputes to come.

Valuations. The court's decision shows why merely obtaining an appraisal may not be enough either to satisfy the IRS or to prevail in litigation. While not explicitly stated by the court, the facts detailed in the court's opinion strongly indicate that the terms of the conversions were set well before the results of the appraisal was known. The primary lawyer for the conversions, Kirkland, apparently had not even intended to obtain an appraisal, and only sought one when the tax lawyer, Pettis, urged him to do so. The boards for the Sta-Home EOs authorized the conversions on 7/11/95, more than six weeks before the appraisal was finalized. The court noted that although Kirkland waited until Hart's accounting firm finished the appraisal to proceed with the conversions, Kirkland had assumed that the appraisal would show that the liabilities of the Sta-Home EOs exceeded the value of their assets.

These facts indicate that there was significant momentum to complete the conversions on the terms under which they ultimately occurred, before the Sta-Home EOs had complete information about the value of their assets. This momentum may explain why the conversions proceeded on these terms even though Pettis had serious reservations about both the first and the second iterations of the appraisal. Pettis had in fact identified the very issue that became the focus of the court's concern, the failure to assign an adequate value to the substantial intangible assets of the Sta-Home EOs.

The appraisal may have served at least one purpose, in that it may have been part of the reason why the IRS conceded that the directors of the Sta-Home EOs were not liable for the Section 4958 manager's tax. This is probably of small comfort to the Caraccis, however, since the $30,000 in total manager's tax pales in comparison to the almost $1.3 million in first-tier Section 4958 taxes based on the court's valuation decision. This case therefore demonstrates why it is important not only to obtain an appropriate appraisal, but to provide sufficient time for that appraisal to be reviewed and corrected as needed, as well as to leave the terms of the transaction sufficiently flexible to accommodate the results of the appraisal.

Revocation. The court's decision to reverse the revocation of the Sta-Home EOs' tax-exempt status is the most interesting aspect of the case. The court in effect created a "single transaction" rule—one excess benefit transaction, no matter how large, is insufficient to justify revocation. The court did not even address the magnitude of the transaction, finding that the availability of intermediate sanctions to correct the transaction made revocation inappropriate, apparently without regard to the portion of the tax-exempt organization's assets involved. It is certainly questionable whether Congress intended the size of a transaction be disregarded for purposes of determining whether revocation in addition to the imposition of intermediate sanctions is appropriate, but the court nevertheless reached that conclusion.

Another interesting aspect of the decision is that the court was apparently untroubled by the fact that the Sta-Home EOs had been dormant since the date of the conversion over five years earlier.

This may simply have been because none of the parties raised this issue, so the court was only faced with revocation based on the conversions, not on inactivity. Nevertheless, the fact that the court found that the exemption of the Sta-Home EOs should be preserved despite their dormancy, in part to facilitate the correction of the excess benefit transactions, at least creates some precedent for holding that as long as a tax-exempt organization does not engage in activities contrary to its tax-exempt status, the lack of activities that further its tax-exempt purposes for some period in its history, even a sustained period, will be irrelevant.28

The court's third reason for reversing the revocations, to facilitate correction of the excess benefit transactions, is less compelling under the recently finalized Section 4958 regulations, which were not in effect when the conversions occurred. Those regulations provide that if the Section 501(c)(3) organization that originally provided excess benefits is no longer in existence or is no longer tax-exempt, correction can be accomplished by repaying the excess benefits to another Section 501(c)(3) organization selected in a manner consistent with the dissolution provisions in the original Section 501(c)(3) organization's governing documents. One interesting aspect of this option, however, is that the disqualified persons involved cannot be disqualified persons of the substitute Section 501(c)(3) organization, which might have caused serious problems in this situation if the revocations had been upheld and the Section 4958 regulation had applied, given the critical role the Caraccis played in managing the home health care businesses at issue.29

Where from here?

The Tax Court did not enter a decision in these consolidated cases until 7/17/02, so there is still ample time left in the 90-day appeal period for any of the parties to appeal the court's decision. For the petitioners, successfully appealing the valuation decision will be a challenge. Not only did the court provide a detailed basis for its decision, supported by the testimony of the Service's expert witness, but valuation decisions are factual questions and therefore subject to a clearly erroneous standard on appeal.30

For the Service, the task is somewhat easier in that the revocation decision was a question of law and so would be subject to de novo review on appeal.31 The Service however, may not want to appeal this decision, but instead try to obtain a more favorable decision in a situation covered by the Section 4958 regulations. As noted above, those regulations weaken one of the three grounds the court gave for reversing the revocations by establishing a correction mechanism for when the original Section 501(c)(3) organization has lost its tax-exempt status.

It is important to recognize that this case did not raise many issues that will likely prove critical in later intermediate sanctions cases, including the following:

- ***Disqualified persons.*** Petitioners did not seriously contest that they, and their for-profit companies, were disqualified persons. Given that three members of the Caracci family were the directors of the Sta-Home EOs, and five members of the family were the only owners of the Sta-Home for-profits, this is understandable.
- ***Rebuttable presumption.*** No attempt was made here to invoke or rely on the burden-shifting effect of the rebuttable presumption. It would have been somewhat prescient of the

Caraccis to have done so; the legislative history describing the presumption had yet to be drafted, much less the detailed instructions provided by the regulations.

- ***Regulations.*** The transaction occurred well before the issuance of the proposed regulations on 8/4/98, the temporary regulations on 1/10/02, and the final regulations on 1/23/02. The interpretation of those regulations was therefore not at issue.
- ***Effective date.*** Petitioners did not ultimately contest that the transactions occurred after the 9/14/95 effective date of Section 4958. Given that the deal documents were not completed until the second half of October 1995, effective October 1, 1995, it can be seen why the petitioners abandoned this argument. Other taxpayers who engaged in transactions near the effective date may, however, wage a more pitched battle over whether Section 4958 even applies.

Conclusion

Before the enactment of intermediate sanctions, the only penalty available to the IRS to address the Sta-Home situation would have been revocation of the tax-exempt status of the Sta-Home EOs. While there is little doubt that such revocations would have been upheld based on the facts as found by the Tax Court, they also would have been completely ineffectual. The Sta-Home EOs have been dormant since the date of the conversions, so even as taxable corporations they would not have owed any tax. Even if the IRS could convince a court that it was appropriate to revoke their tax-exempt status for the year ending 9/30/95, they had negative net income in that year and so would not have owed any tax. They also did not apparently receive charitable contributions from the Caraccis or any other insider, so there were no donors that could be affected by revocations.

This conclusion does not necessarily mean the case is a perfect endorsement of intermediate sanctions, although it comes close. Presumably the state attorney general, in the exercise of general authority over charitable assets, could have pursued the petitioners and sought to reverse the conversions. One egregious case does not necessarily justify a law that, at least in the eyes of some, places undue burdens on all charitable and social welfare organizations. This situation nevertheless does provide a strong example of why the IRS needed intermediate sanctions to effectively enforce the prohibition on private inurement.

The case also demonstrates the importance, particular in significant transactions with insiders, of both obtaining and using good information on the fair market value of the property involved in the transaction. Obtaining an appraisal to simply paper a deal may be sufficient to avoid the manager's tax, or even to invoke the rebuttable presumption of reasonableness under the Section 4958 regulations, but by itself it may not be enough to avoid IRS challenge or an adverse court decision. Advisors to tax-exempt organizations should note the need to evaluate the sufficiency of appraisals and other expert opinions, and to ensure that the terms of transactions reflect those expert opinions as opposed to the expert opinions simply confirming the predetermined terms of the transactions. The IRS has certainly demonstrated a willingness, if the stakes are sufficiently high, to hire an outside expert and so match the firepower of taxpayers when it comes to expert opinions.

Tax-exempt organizations can, however, take some comfort in another important goal of intermediate sanctions that is now being realized. The decision suggests that the tax-exempt status of such organizations will now be more difficult to revoke based on private inurement, with single or limited transactions unlikely to justify revocation. This is, of course, only one decision, but if the Tax Court continues in this direction and other courts follow its lead, managers of tax-exempt organizations can have some reassurance that inadvertent or one-time transactions that result in excess benefits are unlikely to threaten the existence of the entire organization.

The Caracci decision provides a useful first step for understanding how intermediate sanctions will apply to actual instances of alleged private inurement. While the primary lessons—the importance of accurate valuations, the reduced threat of revocation—are not unexpected, it is useful to have an actual decision to serve as both an example and a guide to how intermediate sanctions may be applied in the future. Practitioners and managers of tax-exempt organizations would be well advised to take its lessons to heart and to continue to monitor future developments in this area that is so important to all Section 501(c)(3) and Section 501(c)(4) organizations.

1 LaFon, "EO Conference Covers Intermediate Sanctions, September 11 Charities," 94 Tax Notes 1588 (3/25/02).
2 The Sta-Home EOs also operated three certified rural health clinics, but these clinics were not financially material to the EOs.
3 See generally Rev. Rul. 68-609, 1968-2 CB 327; Rev. Rul. 59-60, 1959-1 CB 237, modified by Rev. Rul. 65-193, 1965-2 CB 370; Kaiser & Henchey, "Valuation of Medical Practices," Continuing Professional Education, Exempt Organizations—Technical Instruction Program for FY 1996 (1995), page 404.
4 While Hahn's data also included a company with an even lower price-to-revenue ratio (0.18), both Hahn and the court disregarded it for unknown reasons.
5 Citing, among other cases, Scottish Am. Inv. Co., 323 US 119, 32 AFTR 1421 (1944); Mandelbaum, TCM 1995-255, aff'd w/o op., 91 F.3d 124, 78 AFTR2d 96-5159 (CA-3, 1996).
6 Citing, among other authorities, Cartwright, 411 U.S. 546, 31 AFTR2d 73-1461 (1973); Estate of Hall, 92 TC 312 (1989); Rev. Rul. 59-60, 1959-1 CB 237.
7 Citing, among other cases, Estate of Jung, 101 TC 412 (1993); Estate of True, TCM 2001-167.
8 Citing, among other cases, Mitchell, 267 US 341 (1925); Estate of Proios, TCM 1994-442.
9 Citing Kumho Tire Co. v. Carmichael, 526 U.S. 137 (1999); Daubert v. Merrill Dow Pharm., Inc., 509 U.S. 579 (1993).
10 Citing, among other cases, Neonatology Associates, P.A., 115 TC 43 (2000).
11 Citing, among other cases, Orth, 813 F.2d 837, 59 AFTR2d 87-758 (CA-7, 1987).
12 This balance sheet was created for the trial and differed slightly from the unaudited financial statements used by the experts and shown in Exhibit II.
13 Section 4958(a)(1).
14 Section 4958(b).
15 Section 4958(f)(6).
16 Section 4958(f)(5).
17 Sections 4958(a)(2), (d)(2).

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ATTORNEYS

18 Section 4962(a).
19 Sections 4963(e)(1), 6213(a); Regs. 53.4963-1(e), 301.6213-1(a)(2).
20 Section 7481(a).
21 Section 4961(a); Reg. 53.4961-1.
22 See also Reg. 1.501(c)(3)-1(c)(2).
23 Reg. 1.501(a)-1(c).
24 Reg. 1.501(c)(3)-1(d)(1)(ii); see also American Campaign Academy, 92 TC 1053 (1989).
25 Citing Anclote Psychiatric Ctr., Inc., TCM 1998-273.
26 H. Rep't No. 104-506, 104th Cong., 2d Sess. (1996), page 59, reprinted at 1996-3 CB 49 at 107.
27 Id., fn 15.
28 One ramification of dormancy is that the Sta-Home EOs may no longer qualify as public charities. Assuming they qualified as public charities under Section 509(a)(2) before the conversions, the lack of any income during the almost six years since then would cause them to fail the Section 509(a)(2) income tests. If the IRS were to hold, as it appears it would be justified in doing, that the Sta-Home EOs are now private foundations, the Sta-Home EOs would at a minimum have to go through the Section 507(b)(2)(B) process for regaining their public charity status.
29 See Reg. 53.4958-7(e)(2).
30 E.g., Estate of Godley, 286 F.3d 210, 89 AFTR2d 2002-2001 (CA-4, 2002).
31 See, e.g., id.
32

EXHIBIT I: The Family and the Entities.

Victor Caracci & Joyce Caracci
(Consultant) (COO/Admin.)

Michael Caracci (CEO) Vincent Caracci(General Counsel)
& Cindy Caracci & Denise Caracci
Christine McQuillen (Director of Personnel)
& David McQuillen (maintenance man)

Sta-Home EOs	Sta-Home For-Profits
Sta-Home Home Health Agency, Inc.	Sta-Home Health Agency of Jackson, Inc.
Sta-Home Home Health Agency,Inc., of Forest, Mississippi	Sta-Home Health Agency of Carthage, Inc.
Sta-Home Home Health Agency,Inc., of Grenada, Mississipp	Sta-Home Health Agency of Greenwood,Inc.

EXHIBIT II: Sta-Home Combined Financial Statements.

Year	Revenue	Expenses	Net Income (Loss)
1991	$12,345,191	$12,226,606	$118,585
1992	18,625,011	18,597,256	27,755
1993	26,751,518	26,924,893	(173,375)
1994	35,416,609	35,588,999	(172,390)
1995	45,208,968	45,715,681	(506,713)

Year	Assets	Liabilities	Deficit
1991	$ 3,203,759	$ 3,787,285	($583,526)
1992	5,404,925	5,960,696	(555,771)
1993	6,910,710	7,639,855	(729,145)
1994	7,515,492	8,417,027	(901,535)
1995	10,736,407	12,144,655	(1,408,248)

The figures for revenue and expenses are drawn from the expert reports; the court reported slightly different figures for unknown reasons.

EXHIBIT III: Comparison of Valuations.

PETITIONERS (HAHN)
Asset Approach Asset Value: adjusted balance sheet (best case) $11,757,459
Asset Value: adjusted balance sheet (base case) 10,521,977
Market Approach Best case sales price to revenues multiple 0.26
Best case sales price to total book assets multiple 1.10
NET ASSETS (BEST CASE)ASSET VALUE ($11,757,459) - LIABILITIES $12,345,655)
(588,196)
COMMISSIONER (WILHOITE)
Market Approach MVIC: publicly traded multiple of 0.30 $13,563,000
(revenue multiple) MVIC: merged & acquired multiple of 0.25 11,302,000
Income Approach MVIC: cost-shifting income stream 11,001,000
Average MVIC MVIC: weighted averaged of three figures 11,604,000
Asset Value Average MVIC $11,604,000
- Working capital infusion (2,020,000)
+ Current liabilities 11,274,000 20,858,000
NET ASSETS ASSET VALUE (20,858,00) - LIABILITIES (13,310,860) 7,547,140
COURT
Market Approach MVIC: guideline company multiple of 0.25 $11,300,000
Asset Value MVI $11,300,000
+ Current liabilities 11,475,000
- Long-term debt (4,100,000) 18,675,000
Market Approach Sales price to revenues multiple 0.42

(based on Hahn)	Sales price to total book assets multiple	1.75

NET ASSETS ASSET VALUE (18,675,000) - LIABILITIES (13,511,000) 5,164,000

The figure for liabilities is based on the audited figures generated for trial.