Avoiding the Snares of Intermediate Sanctions

To avoid new penalties, be sure you meet these criteria.

BY SARAH J. SCHMIDT

BESIDES STEERING YOUR ORGANIZATION clear of tax code violations, you now have something else to worry about: personal liability for penalty taxes on any "excess benefits" you receive. A new law, passed this summer, provides the IRS with intermediate sanctions—penalties to use against insiders who benefit personally from their positions at charitable organizations. "Insiders" include officers, directors, and others with the power to control the organization.

Efforts to pass such legislation began as early as 1993 when then–chair of the House Oversight Committee, Rep. J.J. Pickle (D–TX), held a series of hearings. These hearings were triggered by the trial of former United Way president, William Aramony, later convicted on numerous fraud counts. Many in the nonprofit community, including the IRS, had long championed intermediate sanctions as a regulatory tool for several reasons. First, such sanctions punish wrongdoers, rather than charities. Second, they're an alternative to the severe penalty of revoking a charity's tax–exempt status.

Who & What Does the New Law Punish?

Part of a larger piece of legislation known as the Taxpayer Bill of Rights II, the intermediate sanctions portion of the bill aims at one thing: curbing private inurement that occurs from excess benefit transactions. The long–standing private inurement prohibitions penalize organizations by revoking their exempt status. The new intermediate sanctions law, on the other hand, imposes penalty taxes on insiders at 501(c)(3) and 501(c)(4) organizations (except for private foundations) that engage in excess benefit transactions. The law also charges excise taxes against managers who knowingly participate in these improper transactions. The IRS now has authority to impose these taxes instead of *or* in addition to revoking an organization's exempt status. Thus, the new law encourages greater accountability by nonprofit leaders while providing the IRS with a potent new enforcement tool.

Proper documentation of compensation agreements is essential.

Excess Benefits. The law defines "excess benefit transactions" as arrangements "in which an economic benefit is provided by an exempt organization directly or indirectly, to or for the use of any disqualified person, if the value of the economic benefit provided exceeds the value of consideration (including the performance of services) received for providing such benefit."

That definition is so broad that it even includes benefits provided through an entity that is merely *controlled by* the exempt organization. For example, if a

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tax–exempt parent organization instructs its subsidiary to pay excess compensation to the parent organization's president, then a prohibited excess benefit transaction has probably occurred. This definition could also include transactions such as below–market–rate or interest–free loans offered by the organization. Whether the value of a benefit is deemed "excess" will depend on whether it's reasonable.

Three Criteria for Reasonable Compensation. In determining reasonable compensation, the law establishes a "rebuttable presumption," meaning that compensation is presumed reasonable if it meets three criteria:

1. It must be approved by an independent board or committee composed entirely of individuals unrelated to and not subject to the control of the person whose compensation is in question.
2. The committee must obtain and rely on appropriate data on comparable positions and what they pay.
3. The committee must adequately document the basis for its determination.

A reciprocal arrangement—such as a scheme in which someone approves compensation for an executive and the executive then approves compensation for the other individual—would not satisfy the first criteria. Data necessary to satisfy the second criteria might include:

- compensation rates paid by similarly functioning and located organizations, either taxable or tax exempt. For instance, a tax–exempt hospital might use data on compensation that a local for–profit hospital pays to its president.
- compensation surveys supplied by nationally recognized firms
- written offers from similar organizations competing for the same person's services.

The same three criteria apply if, instead of compensation, an organization transfers property to or from an insider. If the organization reimburses excise taxes, pays personal expenses, offers non–fair–market–value transactions, or pays insurance premiums for excise tax liability for the individual, such payments are all considered excess benefits unless they are included in the person's compensation package. In that case, the total compensation package is then subject to the reasonableness requirement. This prohibition does not apply to membership benefits that individuals receive through membership in a nonprofit organization, such as museum store discounts or admission fees (although the extent of this member benefit exclusion won't be completely clear until the IRS issues official guidance, expected no earlier than 1997).

If an organization can prove these three criteria, then the IRS must present sufficient evidence to the contrary in order to impose any penalties. One way the IRS could do so is to prove that the organization relied on outdated or inaccurate data or used comparability figures for unrelated employment or positions. There-fore, proper documentation and thorough investigation *before* reaching compensation agreements with executives and insiders are essential to reducing this risk.

Disqualified Persons. According to the new law, the IRS can penalize any "disqualified persons" who receive excess benefits. Disqualified persons include anyone with substantial influence over the organization's affairs. They may be managers, officers, directors, or employees of the organization. They may even be employees of a subsidiary of the exempt parent organization.

Officers, directors, and trustees don't become disqualified merely by virtue of their titles. Only if they exercise substantial influence over the organization are they disqualified. Therefore, "honorary trustees" or other figurehead positions that lack true power would not automatically be disqualified.

Anyone who was a disqualified person during the five years before the transaction at issue is still considered disqualified. Certain family members of a disqualified person, including siblings and their spouses, are also disqualified. Any corporation, partnership, trust, or estate in which the disqualified person owns more than 35% of

What Steps Should You Take?

- Identify people in your organization whom the IRS may target as "disqualified persons." These include anyone with substantial influence over your organization's decisions. Take special care with all compensation and other benefit arrangements you make with these people.
- Form an impartial committee to be in charge of making compensation decisions.
- Find organizations comparable to yours in function and location. Prepare to use up–to–date data from these organizations in making your own organization's compensation decisions.
- Be prepared to study each compensation decision thoroughly and document it extensively in writing.
- Be sure that your organization has strong conflict–of–interest policies in place.
- Review compensation and other benefit transactions that have occurred during the IRS's special grace period—from September 13, 1995 to January 1, 1997. You can apply the three criteria for reasonable compensation to these transactions after the fact.

the combined voting power of stock, profits, interest, or beneficial interest is also disqualified.

What Are the Penalties?

At the core of the intermediate sanctions law are stiff penalty taxes on anyone who violates the excess benefit prohibitions. Disqualified persons and organization managers are personally liable for these taxes.

Penalties on Disqualified Persons. Disqualified persons are subject to two penalty taxes, which are imposed on the individual but not the organization. A first–tier tax, equal to 25% of the amount of the excess benefit, is imposed on disqualified persons who benefit from an excess benefit transaction. It is computed by one of three methods:

- the amount by which a transaction differs from fair market value
- the amount of compensation exceeding reasonable compensation
- the amount of a prohibited transaction based on the organization's gross or net income.

A second–tier tax is imposed on disqualified persons if they don't correct the excess benefit within a specified time. This tax is a whopping 200% of the amount of the excess benefit.

Penalties on Organization Managers. If that 25% first–tier tax is imposed on a disqualified person, then an additional 10% tax may be levied against any organization manager who participated in the excess benefit transaction with the knowledge that it was improper. An "organization manager" is defined under this provision as any officer, director, or trustee of an exempt organization—or anyone who has powers or responsibilities similar to officers, directors, or trustees. Thus, this category is quite large. It encompasses practically anyone who has final authority for decision–making or spending in an organization.

Again, this tax is imposed on the individual, not the organization. Managers may escape this penalty if their participation wasn't willful or was due to some other reasonable cause. The maximum penalty against any manager under this provision is $10,000.

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When Is the Law Effective?

Intermediate sanctions became retroactively effective September 14, 1995, although the law's actual passage date wasn't until July 30, 1996. A special grace period was granted for transactions entered after September 13, 1995, and before January 1, 1997, however. For these transactions, the law recognizes the same rebuttable presumption of reasonableness, discussed above, if the parties satisfy the three criteria within a reasonable period after entering the compensation package. In other words, the criteria may be accomplished *after the fact* in these limited situations. But for all transactions entered after December 31, 1996, the three criteria must be satisfied *before* the transaction begins. ■

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