New Regs Unravel Intermediate Sanctions Snares

The IRS has clarified some of nonprofits' most troubling concerns about the Intermediate Sanctions Law. Here are the basics.

BY SARAH J. SCHMIDT

Intermediate Sanctions—the 1996 law that gives the IRS penalties to use against insiders who benefit personally from their positions at charitable organizations—rose to the forefront again recently when the IRS issued new temporary regulations explaining certain enforcement and interpretation issues. Nonprofit executives now have greater clarity in how to avoid personal liability and penalty taxes on any "excess benefits" they receive. The main issues addressed by the new regulations are highlighted below.

Who's Subject to Penalties?

Intermediate sanctions apply to "disqualified persons" who receive "excess benefits" from the exempt organizations they serve.[1] Disqualified persons are in a position to influence the organization's affairs. They may be managers, officers, directors, employees, or others in an influential position within the organization. A disqualified person may even be a volunteer or employee of an exempt or non-exempt subsidiary organization.

However, the new regs explain, the mere title of "officer, director, or trustee" doesn't necessarily produce a disqualified person. Whether people are "disqualified" depends on their power within the organization. For example, the regs define someone with the typical power of a treasurer or chief financial officer as a disqualified person, but not necessarily someone with only authority to sign drafts or authorize electronic funds transfers.

The regs also offer additional factors that the IRS will use to determine whether someone has substantial influence in an organization, such as the following:

- Did they found the organization?
- Do they share authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees?
- Do they manage a discrete segment or activity of the organization that represents a substantial portion of the organization's activities, assets, income, or expenses?
- Do they own a controlling interest (measured by vote or value) in a corporation, partnership, or trust that is disqualified?

Who's *Not* Subject to Penalties?

In response to the Seventh Circuit Court of Appeals ruling in *United Cancer Council v. Commissioner*, the new regulations provide an exception that many are calling "a first bite at the apple."[2] Better described as an "initial contract exception," the provision says that Intermediate Sanctions won't apply to "any fixed payment made to a person pursuant to an initial contract, regardless of whether the payment would otherwise constitute an excess-benefit transaction."

An initial contract is one between an exempt organization and someone who was not a disqualified person immediately before entering into the contract. In other words, if a fundraiser enters a first-time contract with an exempt organization (as occurred in the *United Cancer Council* case), the fundraiser won't be subject to Intermediate Sanctions *even if* the benefits the fundraiser receives might otherwise be considered excessive under an Intermediate Sanctions test.

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Naturally, the regs also apply certain limitations to this exception. The amount of the fixed payment can't be subject to any one person's direction, for example. A fixed payment would also not include amounts paid under a reimbursement arrangement where any one person exercises discretion regarding the amount of expenses incurred or reimbursed.

What Are the Penalties?

Disqualified persons who violate the excess-benefit prohibitions are subject to a number of stiff penalties, from a 25% tax on the value of the excess benefit received, up to a whopping 200% tax if they don't correct the transaction within a specified period. These taxes are imposed on the individuals, not the organization, but the organization may still be subject to the loss of its exempt status if the IRS elects to pursue that route.[3]

The new regs say that a disqualified person must repay the exempt organization in cash or cash equivalents to avoid this 200% penalty, and the repayment must include interest from the time the excess benefit occurred to the time of repayment. The regs make clear that the IRS prefers cash repayment, but one provision in the regs permits the disqualified person and the exempt organization to enter an agreement regarding the return of property. Any such agreement must, however, permit the organization to "always refuse the return of that property as payment, and require instead that the disqualified person make a payment in cash (or cash equivalents) of the full correction amount."

If returning the property results in less repayment than what is necessary to correct the full amount of the excess benefit, then the disqualified person must make an additional cash payment to the organization to satisfy the difference. (Conversely, if the payment made by returning the property exceeds the correction amount, the organization may pay the difference to the disqualified person.) If the exempt organization no longer exists at the time repayment must be made, then the disqualified person should pay the correction amount to another exempt organization–an organization that's in no way related to the disqualified person.

What Don't the Regs Do?

The new regs don't address revenue-sharing transactions, although many practitioners had hoped the regs would resolve the question of how such transactions stack up under Intermediate Sanctions. That question will have to wait for future clarification, possibly in the form of additional IRS regulations.

Speaking at a meeting of the American Bar Association, Susan Brown, a Department of Treasury attorney, said, "We're comfortable that subjecting revenue-sharing transactions to the general fair market value standard will reach most if not all improper transactions. Right now, we don't see a need for a second level of tests when the compensation is revenue-based."[4]

The regs also fail to address questions regarding donor-advised funds. Instead, the IRS has requested comments about "potential issues raised by applying the fair market value standard of section 4958 to distributions from a donor-advised fund to (or for the use of) the donor or advisor." This, too, presumably awaits future regulations.

What's Next?

The temporary regulations may have disappointed some in the nonprofit community because of their silence on several troublesome issues. But in other respects, the regs bring welcome relief from uncertainty over many aspects of Intermediate Sanctions.

Although the regulations are considered temporary, with a life span of only three years, they are binding in the same manner as final regulations during that period. They will most likely be revised and reissued as final regulations at some point during their temporary period. This means nonprofit executives and managers should become familiar with the regulations and consult legal counsel for advice on how to avoid any resulting liabilities. ■

Footnotes

[1]"Excess benefits" are defined as benefits provided by an exempt organization directly or indirectly, to or for the use of any disqualified person, if the value of the economic benefits exceeds the value of consideration (including the performance of services) that the organization receives for providing such benefits.

[2]*United Cancer Council v. Commissioner*, 165 F. 3rd 1173 (7th Cir. 1999), 109 T.C. 326 (1997).

[3]See Fram & Spaull in "Selected Resources."

[4]Brown's comments came during a presentation she and other IRS and Treasury officials made at the January, 2001, meeting of the Exempt Organizations Committee of the American Bar Association Section of Taxation, held in Scottsdale, Ariz. She is quoted in *The Exempt Organization Tax Review*, Feb., 2001, p. 151.

Selected Resources

Fram, Eugene H. and Elaine Spaull, "Expectations for Nonprofit Boards Are Changing," *Nonprofit World*, Vol. 19, No. 3.

"IRS Clarifies Intermediate Sanctions Law," *Nonprofit World*, Vol. 19, No. 3.

Muehrcke, Jill, ed., *Law & Taxation, Leadership Series*.

Schmidt, Sarah, "Avoiding the Snares of Intermediate Sanctions," *Nonprofit World*, Vol. 14, No. 6.

Tesdahl, D. Benson, "Don't Wait for Intermediate Sanctions Guidance," *Nonprofit World*, Vol. 16, No. 1.

Winsler, Heidi, "How to Be Sure Compensation Is Reasonable," *Nonprofit World*, Vol. 17, No. 1.

These resources are available from the Society's Resource Center, 608-274-9777, Ext. 221, www.danenet.org/snpo.

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