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New Penalties Proposed for Nonprofits

Be sure your officers, directors, and other "insiders" aren't gaining excessive benefits.

BY D. BENSON TESDAHL

Many people believe that last year's attempts to punish errant nonprofits died with health care reform. Far from it. The Treasury Department has resurrected earlier proposals to enact new penalties against 501(c)(3) and 501(c)(4) nonprofit organizations.

The new penalties are aimed at nonprofits that violate the "private inurement" doctrine. This doctrine makes it unlawful for nonprofit assets to be used for the benefit of "insiders" (such as officers, directors, and others with the ability to control the organization). For example, it is unlawful for a nonprofit organization to:

- pay excessive compensation
- pay an excessive amount for goods or services
- make below-market-rate loans
- let the organization's assets be used for an insider's personal purposes.

At present, there's just one way to punish nonprofits that violate this doctrine: Take away their tax-exempt status. Congress realizes this is a harsh penance, however, and that it can cause more harm than good. Once they lose their tax-exempt status, nonprofit organizations typically dissolve. Thus, the public is deprived of the organization's programs, while the person who unlawfully used the organization's assets typically receives no real punishment.

The new proposal corrects this problem by offering other, less severe punishments. It amends the Internal Revenue Code so that the IRS could impose so-called "intermediate sanctions." Rather than revoke the organization's tax-exempt status, the IRS could tax the insiders who broke the law.

In the Treasury proposal, insiders are called "controlling persons." They are defined as people "in a position to exercise substantial influence over the affairs of the organization." Also included in this definition are insiders' family members and entities in which an insider has a 35% interest.

The Treasury proposal imposes a two-tiered excise tax when private inurement occurs. The first tax is 25% of the excess benefit received by the insider. If the insider does not correct the problem, a second tax of 200% may follow.

In addition to imposing these taxes, the proposal would add new questions to nonprofits' annual information returns (Form 990s). On the new forms, nonprofits would be asked to reveal all transactions with insiders. The idea is that, with greater disclosure, the public can monitor the activities of charities and their insiders.

There are two items of good news in the proposal. First, the proposal pre-

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sumes that a transaction is not an excess benefit if the organization can show that the board:

(1) delegated decision-making authority to someone who didn't have a conflict of interest;

(2) considered relevant information concerning the decision;

(3) documented the basis for the board's decision; and

(4) approved the transaction, including a limit on the amount that could be transferred to the insiders. As long as you can demonstrate these facts, the insiders will not face excise taxes.

Second, the proposal allows organizations to purchase insurance for its insiders. With such insurance, insiders would not be liable for the excise taxes. However, insurance payments for these taxes would have to be included in the insider's income.

Whether this latest proposal becomes law remains to be seen. What does seem clear is that, sooner or later, some form of tax against nonprofit officers, directors, and other insiders is inevitable. In addition, nonprofits can expect more questions on Form 990 about transactions with insiders.

To be prudent, therefore, you should review your organization's compensation practices and other arrangements with insiders. Be certain all such practices are well within the bounds of the law. ■

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Legal & Tax Software Resources

A-Plus-Tax 990 nonprofit tax software, Arthur Anderson Tax Technology Group, 2805 Fruitville Road, Sarasota, Florida 34237 (phone 813-365-9469; fax 813-957-4164).

*Nonprofit Organizations' Business Forms, Disk Edition.

*Starred resources are available through the Society for Nonprofit Organizations' Resource Center. To order, see the Society's Resource Center Catalog, included in this issue, or contact the Society at 6314 Odana Road, Suite 1, Madison, Wisconsin 53719 (800-424-7367).