Nonprofit organizations fall under two IRS regulations: Form 990 and the Intermediate Sanctions Act. Both include requirements that board members are obligated to follow. Yet many board members are unaware of these duties. Most board members know about Form 990, but few know that they have duties in regard to it. And many don’t even know about the Intermediate Sanctions Act. With the IRS aggressively enforcing the Act to eliminate faux nonprofits, unwitting nonprofit board members and managers can find themselves in trouble. Let’s look more closely at these two obligations.

**Duty #1: Form 990**

One regulation requires the organization to file IRS Form 990 each year, including answers to 38 questions on governance operations. Many board members don’t realize they need to be involved in preparing answers to these questions every year.

If there were an audit involving the 38 board questions, board members would be expected to know about any exceptions to be reported, such as conflicts of interest. For example, any board member whose firm has a business relationship with the nonprofit must specify it as a conflict of interest on Form 990 and probably abstain from voting on related issues.

Also, if the report is late, the nonprofit must file another IRS form, and the board needs to be advised of the situation. If your organization ignores any of the requirements, you can lose your tax-exempt status — a penalty that the IRS has already imposed on thousands of nonprofits. In some instances, moreover, failure to heed the requirements might leave nonprofit board members open to personal liability for failing in their duties of “due care.”

**Duty #2: Intermediate Sanctions Act**

Another obligation to which nonprofits must adhere is the Intermediate Sanctions Act (“the Act”). Although they can be financially ensnared by the 20-year-old act, very few nonprofit board members seem to know it exists. They are generally aware that their organizations can be in trouble if they pay unreasonable compensations. But many are unaware of other sections of the Act that can lead to personal liability for board members, senior managers, and even such tangential people as volunteers and vendors.

You can be held personally responsible — and punished accordingly

The key to the Act is the “excess benefit.” Excess benefits cover more than above-market wages. The IRS may consider it an excess benefit if your organization pays an above-market price for a product or service or has disadvantageous financial arrangements with other organizations. A fundraising group that receives an excessively generous travel budget from a nonprofit group can be in violation of the Act. Those giving and those seeking an excess benefit can both be liable.

The Act specifies who may be liable under its provisions, calling them “disqualified persons.” Disqualified persons include organization officers, board members, and their relatives. The disqualified persons category also can be extended to people not on the staff or board if they’re in a position to exercise substantial influence over the organization’s affairs. For example, if a volunteer agrees to chair a program task force, that person may be considered a disqualified person. Major donors also may fall into this category, even if their only role is to provide resources. The legal reasoning is that such people can make a major impact on your organization’s operations. Those receiving the benefit as well as board members and managers approving it are all subject to the Act.

The IRS levies penalties in an unusual way. Penalties are added to the personal income tax bill of the individuals found responsible.

Even donors, volunteers, and vendors can face personal penalties.
For example, if a nonprofit were found to have paid $150,000 to a disqualified person in a transaction for which $100,000 was fair market value, the disqualified person would have to pay 25% of $50,000 ($12,500) to the IRS. The disqualified person would also have to return the excess benefit of $50,000 to the organization or be subject to a 200% penalty ($100,000).

If a benefit isn’t included in the recipient’s W-2 form, it’s considered an automatic excess benefit that must be reported on the public IRS Form 990. The IRS has the power to revoke the tax-exempt status of any organization that’s found guilty of an excess benefit transaction.

Well-meaning nonprofit directors, managers, or even volunteers who unwittingly approve an excess benefit are at risk. In some states, nonprofits such as medical facilities are required to have current or former clients on their boards, which could leave some low-income people facing significant tax liabilities. And few D&O policies cover the legal costs that such people may incur.

Naïveté about the Act extends beyond untutored board members. Attorneys, CPAs, and other professionals are often uninformed about this law. One CFO failed to add an excess vacation benefit to an employee’s income. If the organization’s auditor hadn’t found the error, the IRS could have deemed it an automatic excess benefit. Obtaining a claim rescission would have entailed substantial legal costs and management time.

BOARD EDUCATION IS CRITICAL

In sum, ignorance of the Intermediate Sanctions Act can be financially devastating to well-meaning people. Nonprofit board education is needed in this area. In particular, all board members ought to:

Be alert. Every board member should know that the Act covers much more than paying appropriate salaries and identifying disqualified persons. Well-meaning outsiders, such as donors and revenue-sharing organizations, could be deemed part of an operating partnership and entrapped by the Act.

Know about compensation and benefits. Nonprofits frequently delegate compensation decisions regarding the executive director or CEO to the board chair or a few senior board members. But that’s not enough. The entire board should review all salary schedules every year. If questioned by the IRS, every board member should know the compensation of the three or five (depending on the number of employees) highest-paid people. All this needs to be completed before a salary increase is awarded.

Keep good records. If your organization is audited by the IRS, you’ll need records of any transaction being questioned. Board members who are unsure whether a transaction might involve an excess benefit should ask the board to seek competent legal counsel. The existence of an excess benefit could well be fact-based, in light of practices of comparable organization, or it may fall in a gray area. In either case, counsel can flag whether the potential exists
for the payment or benefit to be deemed an excess benefit. If the board refuses to accept the view of counsel, board members who perceive it to be an excess benefit should vote “no” on the transaction and make certain their votes are clearly recorded in the meeting minutes in order to avoid liability. When in danger of approving an excess benefit, it’s not a good idea to “go along to get along,” a culture that seems to pervade nonprofit boards.

Know about safe harbor provisions. The IRS says boards should take certain actions before making any decision that might be construed as involving an excess benefit — for example, using organization funds to support an executive director’s trip to Europe after 20 years of service. The board should first appoint a group of disinterested board members or a formal board committee of disinterested people to approve such a transaction. The board should ensure that the group’s decision rests on comparable data gathered by disinterested field experts. For the European trip, it would be best to determine if such a reward is standard industry practice in case the IRS questions the transaction.

Make sure that all directors’ and officers’ (D&O) liability insurance policies cover excess benefit tax sanctions. If not, seek such coverage.

Have counsel review bylaws, operating guidelines, principles, and policies to check that all compensation processes and other major transactions comply with the Intermediate Sanctions Act.

Be certain that the annual conflict of interest statement signed by board members, managers, and other disqualified persons includes reference to the Intermediate Sanctions Act.

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