



Don't Wait For Intermediate Sanctions Guidance

The new law can be a trap for unwary nonprofit managers. Here are rules to follow to make sure you don't incur the large penalties.

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The recent Taxpayer Bill of Rights II added section 4958 to the Internal Revenue Code, which establishes so-called "intermediate sanctions" in the form of excise taxes that can be imposed on certain individuals receiving an excessive benefit from their dealings with a charity or social welfare organization. The IRS promised to come out with regulations elaborating on the requirements of section 4958, but it has so far failed to do so. In the meantime, nonprofit managers are left with an obligation to obey the law, but without meaningful guidance on how to do so.

Because the new intermediate sanctions law can be a trap for the unwary, this article gives exempt organizations and their managers some useful rules to follow until IRS regulations are issued.

What Are "Intermediate Sanctions"?

With the addition of section 4958 to the Code, the IRS now carries a new weapon, short of revoking tax exemption, to punish excessive benefits received by those dealing with both public charities (other than private foundations) and social welfare organizations. (This article refers to both generically as "exempt organizations.") These intermediate sanctions will probably be the sole sanctions, and revocation of tax exemption will likely not occur except in the most extreme cases.

Briefly stated, the new law provides that, if a "disqualified person" is engaged in an "excess benefit transaction" with an exempt organization, that person can be made to pay a tax equal to 25% of the amount of excess benefit. An organization manager (trustee, director, or officer) who knowingly approves an excess benefit transaction must also pay a tax of 10% of the amount of excess benefit. If the disqualified person does not pay the tax and correct the transaction within a specified time, an additional tax equal to 200% of the excess benefit can be assessed.

The impact of the new sanctions may be dramatic. Indeed, these new excise taxes could easily result in the bankruptcy of offending "insiders." For example, if a CEO with substantial influence over a large charity receives a salary of \$150,000 per year, and if the IRS later determines that reasonable compensation for this individual during each of the past three years should have been only \$100,000 per year, that CEO would have to:

- pay a tax of 25% of the amount of the excess benefit received each year ($25\% \times \$50,000 \times 3 \text{ years} = \$37,500$) *and*
- correct the transaction by paying back to the organization the amount of the excess benefit received ($\$50,000 \text{ per year} \times 3 \text{ years} = \$150,000$).

Thus, the CEO's total liability is **\$187,500, plus interest!** In addition,

failure to repay this amount within a certain specified time results in an additional 200% tax. All organization managers who approved the compensation knowing that it was excessive would also be subject to a tax equal to 10% of the excessive amount ($10\% \times \$50,000 \times 3 \text{ years} = \$15,000$).

To avoid violating the law, exempt organizations and their managers need to understand certain key terms used in the statute. Specifically, it is critical to know the following:

1. What information can be used to determine if a benefit is "excessive"?
2. Who is a "disqualified person" subject to the new taxes?
3. If an organization has a board composed of people related to or controlled by a disqualified person, what steps should the board take when approving a financial transaction with that disqualified person?

Let's look at the answers to each of these questions.

When Is A Benefit "Excessive"?

The statute defines an "excess benefit transaction" as one in which an exempt organization provides an economic benefit directly or indirectly to any disqualified person where "the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for



providing such benefit.” Simply put, the law requires that exempt organizations always receive fair market value for property they sell, pay no more than fair market value for property they buy, and pay no more than reasonable compensation for services rendered to them.

But how does an organization know for sure when it is paying “fair market value” or “reasonable compensation”? The short answer is that you never know for sure, but there are several well-recognized sources of comparison data that can be reviewed to lessen the risk considerably.

1. Compensation. Prudent charities should always try to obtain nationally recognized compensation and salary surveys covering the position in question. For some positions, however, salary surveys are not available. In those cases, you should do the following:

- Look at similar-sized exempt organizations to see what they pay for similar job duties.
- Look at for-profit entities that are comparable in terms of size and job duties.
- Consider what your organization has historically paid for the position in question.

With regard to this third factor, however, a word of caution is in order. Exempt organizations must be careful not to assume that compensation is reasonable simply because it reflects the amount a predecessor received for the same position, since that predecessor may have been more highly qualified than the current candidate. The reasonableness of an individual’s compensation depends on a wide array of facts and circumstances, including the employee’s relevant education and work experience.

One of the most difficult situations arises where an exempt organization cre-

ates a new position that is so unique in terms of duties and qualifications that there simply is no available salary data from any source. In such a case, the best advice is to carefully document that the final salary agreed upon was the result of arm’s-length negotiations. The reason is that the IRS generally views good-faith arm’s-length negotiations as a very favorable factor in determining whether compensation is reasonable or excessive.

Documenting the terms and conditions for compensation is particularly important because the new law provides that a person cannot claim that a benefit was received in return for services performed unless the exempt organization clearly indicated an intent to treat it as such ahead of time, rather than after the fact. For example, suppose employees agree to work for a charity at \$15 per hour even though their labor is worth more than that amount. If they later have several personal expenses paid for out of charity funds, they will have received an excessive benefit. They cannot claim that the personal-expense payment was simply additional compensation which, when added to the hourly salary, makes their overall compensation reasonable. The reason is that they agreed to work for only \$15 per hour, and the payment of personal expenses was not part of the agreed-upon salary for the performance of services. Thus, the charity did not receive anything of equal value in return for the payment of the personal expenses.

2. Buying, Selling or Renting Property. If property is being rented from or to a disqualified person, one way to avoid an excessive benefit is to obtain comparison property rental prices from an experienced real estate broker or from the local newspaper. The key, of course, is to make sure that these comparison

quotes are for similar properties. Likewise, for buying or selling real estate, get the opinion of a real estate broker or review real estate sales magazines for similar properties. When it comes to buying or selling personal property (especially used property) from or to a disqualified person, finding appropriate data is a bit more difficult, but even then, you can usually find magazine or newspaper ads showing what similar used property sells for in the community. Armed with such documentation, these transactions should easily withstand IRS scrutiny.

Who Is a “Disqualified Person”?

In assessing whether transactions result in excess benefits, a charity must determine who is a “disqualified person” under the new law. A “disqualified person” is defined in the statute as:

- anyone who was, at any time during the five-year period ending on the date of the transaction, in a position to exercise “substantial influence” over the affairs of the organization
- a member of the family of such an individual
- an entity in which people described in the preceding two categories own more than 35% of an interest.

Thus, the key to determining who is a disqualified person lies in determining who has “substantial influence.” Unfortunately, the statute does not define the term “substantial influence.” And the report of Congress that accompanied the statute merely states that a person with the title of trustee, director, or officer is not automatically considered a disqualified person.

Despite Congress’s statement that a person’s title is not always indicative of influence, a person’s title typically is one of the first things an IRS agent is likely to look at in determining who controls an exempt organization. Moreover, it is far better to be overinclusive rather than underinclusive in determining who has substantial influence. Therefore, in the absence of IRS guidance, it would be prudent for exempt organizations to develop a list of people who should be considered as having substantial influence, and then exercise special caution during any financial dealings with those people. A conser-

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vative list that should easily satisfy the law might include the following:

- all officers
- all directors or trustees
- the founder(s) of the organization
- the largest donor
- the five highest paid employees of the charity.

We recommend the last category above because Schedule A to Form 990 requires exempt organizations to report the names and salaries of the five highest paid employees, thereby suggesting that the IRS considers those positions to be influential and worthy of special scrutiny.

What Steps Should the Board Take?

In enacting the new law, Congress declared that there should be a “rebuttable presumption” that compensation paid to a disqualified person is reasonable if certain steps are taken. Specifically, the presumption will apply if an independent board (or an independent committee of the board) approves the compensation arrangement and that board or committee:

- is composed “entirely” of individuals unrelated to and not subject to the control of the disqualified person(s) involved in the arrangement (in other words, a totally disinterested board)
- has obtained and relied upon “appropriate data” as to comparability, and
- has adequately documented the basis for its determination and the basis for determining that the individual’s compensation was reasonable.

The requirement that the board be “entirely” disinterested is ambiguous, and on its face, could mean that family boards or boards with close friends and business associates could never qualify for the presumption. In the absence of IRS clarification, what should exempt organizations do if they have one or more board members who are related to a disqualified person or who are arguably under that person’s control?

One option is to have all interested directors leave the room and have the remaining disinterested directors vote on the compensation arrangement. Although this may not technically satisfy the

statute, it may be the next best alternative where only one or two people on a board are disqualified and the remaining board members constitute a majority.

But where an organization’s board consists entirely or almost entirely of members of the same family or other people closely affiliated with a disqualified person, having the interested parties leave the room would obviously leave almost no one to vote on the matter. In such cases, consider hiring a disinterested party to review appropriate compensation data and make a recommendation to the board on the reasonableness of a proposed compensation arrangement. A disinterested party could include legal counsel, an independent compensation expert, or anyone else with suitable expertise. While using an independent expert will not qualify the board’s action for the rebuttable presumption of reasonableness, it will at least show the IRS that the board acted in good faith and did everything possible to reach an unbiased and informed decision.

Finally, remember that, even where a board is composed entirely of disinterested people, it would be prudent to develop a conflict-of-interest policy to protect the board from any allegation of impropriety. The policy should require that, before voting on any financial arrangement involving the charity, any director with a potential financial interest or other bias must disclose that fact to the rest of the board so they can make a well-informed judgment as to whether that person is able to vote in the best interests of the corporation. If the conflict is significant, the person should leave the room and not vote on the matter.

Will New Law Be a Nightmare for Well-Meaning Nonprofits?

It is too early to tell whether the new intermediate sanctions law will achieve Congress’s goal of curbing nonprofit abuse, or whether the law will instead become a nightmare for well-meaning nonprofit managers. The IRS’s Exempt Organizations Division has inadequate financial and human resources, and the Treasury Department has been reluctant to issue guidance. Thus, it is unclear how aggressively these new sanctions will be

imposed or how much longer it will be before concrete guidance is issued.

Given this law’s many nuances and the lack of regulations to clarify them, exempt organizations and their managers should proceed with great caution when approving any type of financial transaction involving officers, directors, founders, key employees, and others with potential influence over the organization. When in doubt, seek independent legal counsel, independent compensation experts, or both. In addition, be proactive, and adopt “safe harbor” rules of thumb, such as those outlined in this article. By doing so, you can protect your current leaders and help ensure that talented people are not dissuaded from serving as future officers, directors, and employees of your exempt organization. ■

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