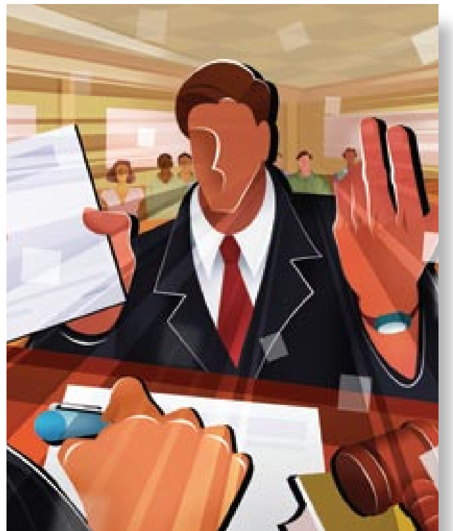

Explain All Executive Benefits … Or Else

IRS penalizes for unfair automatic excess benefits

by Kathryn M. Vanden Berk

Ever since the mid 1990s, the Internal Revenue Service (IRS) has had the power to impose penalties on exempt organization insiders who abuse their positions of authority and control.

These provisions, found in Section 4958 of the Internal Revenue Service Tax Code, are known as "intermediate sanctions" because they allow the IRS to impose a penalty instead of revoking the organization's exemption, and the penalty is imposed on the wrongdoer rather than the organization itself.[1]

Part of the "intermediate sanctions" regulatory scheme allows the IRS to impose a sanction on what are called "automatic excess benefit transactions." These are transactions between the organization and its insiders,[2] and they involve benefits that should have been documented as part of the insider's compensation, but were not.

The insider that I'm referring to in this article is the chief executive of a 501(c)(3) tax-exempt organization. If you are your organization's CEO, president, or executive director, this means you. It is immaterial that your organization might be classified as a public charity as opposed to a private foundation.[3] The scheme works with equal application to both.

If you are an insider, there are three ways that you can get in trouble with automatic excess benefits:

- Agreements that provide hidden and untaxed benefits or that add up to unreasonable compensation when taken as a whole;
- Loans that are too generous, not properly documented, or not repaid; and
- Expense reimbursements, paid to or on behalf of the insider, that are not properly documented, authorized, and/or taxed.

The IRS is willing to back down when you can demonstrate reasonable cause for your failure, but there have to be significant mitigating factors involved. It is always best when you identify in advance any potentially problematic transaction, and document how you deal with it, before the IRS comes knocking at your door.

Penalties are Severe

Correction begins with repayment of 100 percent of the benefit, or payment of income taxes on it if the benefit won't be repaid. In addition, the IRS imposes an excise tax equal to 25 percent of the excess benefit on each transaction. An interesting feature is that the entire amount is treated as excess, regardless of whether it would have been fair compensation had it been handled properly. The insider is liable for the tax.

If the excess benefit transaction is not corrected (either paid back or taxes paid on the income) within the "taxable period,"[4] an additional excise tax equal to 200 percent of the excess benefit is imposed.

There are many IRS rules about how the excise tax is imposed and how it might be mitigated or abated. The main point is that, to avoid the imposition of the 200 percent tax, you must correct the excess benefit transaction during the taxable period.

Safe Harbors are Available

Yes, there is a "safe harbor" to prevent excess benefit transactions. The safe harbor always consists of a proactive response: identifying a troublesome transaction, making sure that it is corrected, and determining what taxes (including excise taxes) must be paid to the government.

What the IRS looks for is "written contemporaneous substantiation" of compliance. That means what it says: You need to document how you handled the transaction both in writing and at the time you take corrective action. Let's look at how you can comply with this requirement.

Executive Agreements. The IRS looks for hidden benefits in the following kinds of executive agreements: employment, deferred compensation, bonus, retirement, severance, and purchase or lease of goods and services.

It asks: When the benefits provided in these agreements are added to the executive's known compensation, is the executive being paid too much overall? When it audits a potential excess benefit, it asks for a tabulation of all elements of compensation for the executive, from every source. When all elements of compensation are totaled, the IRS goes through its own evaluation as to whether the insider's total pay satisfies its reasonableness standard. You need to do your own assessment of reasonableness, using the prescribed method, on a regular basis.[5]

Loans. The IRS looks for loans that are undocumented, unsecured and/or unenforced. It asks: Are the terms so liberal and the likelihood of payback so remote that this constitutes compensation rather than a true loan?[6] When it audits, the IRS wants to see a signed, dated note that has the following information in it: (1) original amount, (2) balance due, (3) maturity date, (4) repayment terms, (5) interest rate, (6) security provided, and (7) purpose of the loan. You need to make sure that any outstanding loans meet this test.

Expense Reimbursements. The IRS looks for expense reimbursements that have been made without an "accountable" (that is, compliant) plan in place or that have been made despite the fact that the insider did not comply with an accountable plan's mandates.

You need to know what constitutes a "fully accountable reimbursement plan" under the IRS Code.[7] If you have no plan, then all reimbursed expenses are income to the insider and all are automatic excess benefits. If you have a fully accountable plan but it was not followed, the result is the same. Be sure you have a fully accountable reimbursement policy for all reimbursable expenses, and be sure you enforce it against your insiders. (See sidebar for sample policy.)

It should be noted that all improperly structured insider agreements, loans, and expense reimbursement are penalized whether or not the underlying amounts are fair or would have been proper with appropriate systems in place.

I should also note that there are many nuances to the system that are too complex to be included in this short article, and which might affect the ultimate outcome.

The important thing to remember is this: The "automatic excess benefit" system has been created to make sure insiders comply with IRS requirements and that they do not use their position to advantage themselves at the organization's—or the taxpayer's—expense.

Go to the *Alliance for Children & Families Magazine* Web site at www.alliance1.org/magazine (click on "Columnists") to review Vanden Berk's fall 2002 article on intermediate sanctions, a "rebuttable presumption of reasonableness" white paper on intermediate sanctions, and sample mobile phone policies. ■

ENDNOTES

1. I wrote about the IRS' scheme of "intermediate sanctions" in the fall 2002 issue of this magazine. The sanctions are set forth in Section 4958 of the Internal Revenue Code.
2. An "insider" is known under Section 4958 as a "disqualified person." Briefly, this consists of persons who exert significant control over the organization, and are usually key employees, officers, directors, and significant donors or members of their families. I use the term "insider" to avoid confusion.
3. The classification scheme is set forth in Section 509 of the Code. The distinction between public charities and private foundations is very important in a number of ways, but for the purposes of excess benefit transactions, either type of exempt organization is liable.
4. To avoid the imposition of the 200 percent tax, a disqualified person must correct the excess benefit transaction during the taxable period. The taxable period begins on the date the transaction occurs and ends on the earlier of the date the statutory notice of deficiency is issued or the Section 4958 taxes are assessed. This 200 percent tax may be abated if the excess benefit transaction subsequently is corrected during a 90-day correction period.
5. For a description of how to create a rebuttable presumption of reasonableness, see 26 C.F.R. §53.4958–6 Rebuttable presumption that a transaction is not an excess benefit transaction. An excellent description of the process and a worksheet to be used, written by IRS' current exempt organizations commissioner Steven T. Miller can be obtained from the Alliance Web site at www.alliance1.org/magazine.
6. Marvin Friedlander, the IRS exempt organizations technical chief, noted at the beginning of 2007 that the IRS was then in the process of examining about 200 loans to insiders. American Bar Association Tax Exemption Exempt Organizations Committee, Jan. 19, 2007.
7. An "accountable plan" is one that meets the requirements of Reg. 1.62-2(c)(2).

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Mobile Phone Policies Can Help Avoid Errors

Sample Policy On Business And Personal Mobile Phone Usage:

When necessary, _(Insert your name)_ provides its staff with company owned wireless phones or encourages its staff to use their personal mobile phones. It is the responsibility of management to identify employees whose job responsibilities makes it essential that they have access to and use of a mobile phone.

Sample Personal Use of Company Owned Mobile Phones:

To ensure that the agency is properly reimbursed for personal use of company owned cell phones, please note the following:

Staff may be assigned mobile phones with plans and limitations based on expected business usage. If an employee uses an assigned cell phone for more minutes than are included in the plan for that phone, the employee must reimburse the agency for all personal calls that cause additional cost for the agency.

Example: A plan allows for 300 minutes per month for a monthly charge of $30. The employee possessing the phone would be responsible for all charges above $30. It is the responsibility of the employee to itemize the bill for the assigned mobile phone and determine which calls are personal.

The employee is responsible for all 411 information calls that exceed $2.

Any additional charges (insurance, text messages, etc) are the employee's responsibility.

It is the employee's responsibility to protect the agency cell phone from any possible loss and/or damage. In the event the employee loses and/or damage the cell phone assigned to them, the employee will be responsible for the replacement/repair cost of the cell phone.