



# It's Time to Get Serious About Intermediate Sanctions

by Kathryn M. Vanden Berk

**SITUATION:** *Following a meeting of the executive committee, the board chair recommends a new compensation package for your executive director. The package is described in general terms and quickly approved. As he's closing his file at the end of the meeting, you overhear him telling another director, "I sure hope no one finds out how much we're paying her, because I'm sure she's being paid more than any other nonprofit director in town. It could really backfire on us."*

**SITUATION:** *You find out that your new development director "suggested" to the banquet company that they hire your largest contributor's wife to manage your annual banquet—the organization's largest fundraising event of the year. After it is over, you find out that not only was she on the payroll of your event, but she was paid a substantial bonus that was then charged back to your organization.*

**SITUATION:** *Your executive director has just purchased a new agency car for himself and asked the CFO to sell his used vehicle to the board chair's daughter. The CFO agrees, and sells the late-model, fully-loaded car to the 20-year-old for \$1,500. The vehicle's blue book value is \$15,000. A bill of sale is quietly buried in the finance office and the car is removed from the agency's fleet.*

In the good old days, shady deals that benefited a tax exempt organization's insiders rarely led to governmental enforcement action—and for good reason. The IRS had only one weapon—its ability to revoke the organization's tax-exempt status. We call this the "atom bomb approach" in reg-

ulation, because the only penalty available to correct the evil would most certainly annihilate the agency.<sup>1</sup>

In the mid 1990s, Congress adopted what we call "intermediate sanctions." This new enforcement tool offers the IRS a way to get at the wrongdoers without having to penalize the organization. The

sanctions are found at Section 4958 of the Internal Revenue Code.<sup>2</sup> Implementing regulations became final this year.<sup>3</sup>

There are a number of key terms that must be absorbed in order to understand how intermediate sanctions work. What I have presented in this article are only the most general definitions [see page 20] and descriptions. If you want to know how these sanctions work in more detail, I suggest that you download two very helpful documents from the IRS Web site called "Easier Compliance is Goal of New Intermediate Sanction Regulations" and "Rebuttable Presumption Procedure is Key to Easy Intermediate Sanctions Compliance." Steven Miller, IRS director of exempt organizations, authored both articles.<sup>4</sup>

## How They Work

First, the scheme requires self-reporting. You may not have noticed this, but your Form 990 annual information return now has the following question:

**"Line 89b:** 501(C)(3) AND 501(C)(4) ORGANIZATIONS. -- Did the organization engage in any section 4958 excess benefit transaction during the year? If "Yes," attach a statement explaining each transaction."

Line 89c requires you to enter the "Amount of tax imposed on the organization managers or disqualified persons

during the year under sections . . . 4958." If you have not noticed these additions, please review your most recent Form 990. I am guessing that you answered "no" to the Line 89b question.<sup>5</sup>

Second, the scheme penalizes the disqualified person (DP) who received the

excess benefit and the organization manager(s) who knowingly approved it. The disqualified person must do two things as his/her tier-one tax: 1) pay the entire excess benefit back to the organization, and 2) pay an excise tax to the government of 25 percent of that amount. If the

DP fails to pay the excess benefit back in a timely manner, the amount to be returned to the organization—the tier-two tax—increases to 200 percent. The organization managers who knowingly approved the transaction must pay 10 percent of the excess benefit as an excise tax, up to a maximum of \$10,000.<sup>6</sup>

Third, intermediate sanctions are designed to be punitive, and they are. Because an excess benefit may span a number of years (as when an executive director receives too much in compensation), the total of tier-one and tier-two taxes can quickly get into the tens, if not hundreds, of thousands of dollars. The same is true if assets are sold. In the first published opinion on intermediate sanctions, the taxes and penalties totaled in the *millions*.<sup>7</sup> Their harshness is intended to encourage compliance, as no one will want to chance their imposition by failing to abide with the law.

Fourth, what constitutes "reasonableness" is a matter of judgment. That means that a transaction's reasonableness will be based upon the validity of an appraiser's valuation (of tangible or intangible assets), or a board's decision as to what constitutes appropriate comparables (for compensation arrangements). These are "facts and circumstances" tests and they can be very subjective. That is why use of the "rebuttable presumption procedure" is so important—it creates a safe harbor for organizations that use it properly.

### What You Can Do

We believe that the IRS is focusing its initial enforcement actions in the health-care field where there have been clear violations of the inurement prohibition, and with egregious and notorious situations—the "low hanging fruit." With these early cases, the IRS will refine its enforcement approach, further define ambiguous terms, get supportive decisions out of the courts, and generally prepare itself for a broader implementation initiative. Therefore, unless you have obvious excess benefit problems, you most likely will have some time to organize your operations so that you will comply with IRS requirements.

## Definitions

**Covered Organization:** All organizations exempt under IRS Sections 501(c)(3) or Sec. 501(c)(4) at any time during the last five years. Private foundations are excluded because they are already subject to their own excise tax laws. We call them "Applicable Tax Exempt Organizations" or ATEOs.

**Disqualified Persons:** Any person in a position to exercise "substantial influence" over the affairs of the organization. This includes officers and directors, key management personnel, substantial contributors, etc. *and* members of their immediate families, *and* any entity owned or controlled, directly or indirectly, 35 percent or more, by them. We call them DPs.

**Organization Managers:** Any manager who participates in a transaction knowing that it was an excess benefit transaction.

**Excess Benefit Transaction:** Any transaction (sale, purchase, lease, salary, or compensation package, etc.) in which an economic benefit is provided by a covered organization directly or indirectly to or for the use of any disqualified person *if* the value of the economic benefit provided exceeds the value of the consideration received for it.

**Reasonable Compensation:** The amount ordinarily paid for like services by like enterprises under like circumstances.

**Rebuttable Presumption Procedure:**

A non-binding procedure published by the IRS that offers organization managers a way to approach a potential excess benefit transaction so that the presumption arises that the transaction did not result in excess benefit. It is "rebuttable" by the IRS. That is, the IRS may prevail if it can prove that the transaction in fact did create an excess benefit.

**First Tier Tax:** Correction of the excess benefit transaction by return of 100 percent of the excess benefit to the ATEO, and payment of an excise tax (equal to 25 percent of the amount of the excess benefit) to the IRS.

**Second Tier Tax:** An additional excise tax (equal to 200 percent of the amount of the excess benefit) that is paid to the IRS if the transaction is not corrected in a timely manner.

**Abatement:** The IRS may abate the excise taxes for both first- and second-tier taxes if the transaction is corrected in a timely fashion.

Information on the IRS "Rebuttable Presumption Procedure" form is reproduced in modified format at the lower right of this page. When you read through it, you should begin to understand what the IRS is looking for. If your board has not already evaluated your senior executive's salary using a format similar to this one, you should probably ask it to do so. The same should be done for any key staff where excess benefit questions might arise. Similarly, if there are transactions between anyone else that falls into the description of "disqualified person" (directors and officers, substantial contributors) and your organization, you should re-examine those transactions closely.

If you believe that an excess benefit transaction has occurred but are uncertain of whether or not the IRS would classify it as such, you should get a professional opinion on the issue. The IRS considers any of the following to be within this group: legal counsel (in-house or outside), certified public accountants or accounting firms, or independent qualified valuation experts. ▲

**Endnotes**

1. By law, no part of the net earnings of tax-exempt 501(c)(3) organizations may inure to the benefit of any private shareholder or individual.
2. Section 4958 of the Internal Revenue Code was created as part of the Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 State. 1452, 1996 C.B. 19.
3. Final regulations were promulgated and became effective on January 23, 2002; T.D. 8978, 67 Fed. Reg. 3076, 2002-7 I.R.B. 500. They will be found at 26 C.F.R. 4958-1 *et seq.*
4. The articles are available on the IRS website at <http://www.irs.ustreas.gov/charities/index.html>.
5. The self-reporting scheme is important. If someone alerts the IRS to an excess benefit transaction that has not been reported, your statement that none occurred will be a false statement.
6. The organization managers' liability is joint and several. Therefore, if three people were involved and only one of them has deep pockets, he/she will be required to pay the entire penalty.

7. In *Caracci v. Commissioner*, 118 T.C. 379; 2002 U.S. Tax Ct. LEXIS 25; 118 T.C. No. 25 (May 22, 2002), the IRS declared an excess benefit of over \$5 million when a home health agency chain undervalued assets during a conversion from tax-exempt to for-profit status. The total due, when first and second tier taxes were imposed as well as capital gains taxes, was \$13.6 million!

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**Rebuttable Presumption Checklist**

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| <ol style="list-style-type: none"> <li>1. Name of disqualified person</li> <li>2. Position under consideration</li> <li>3. Duration of contract (1 yr., 3 yr., etc)</li> <li>4. Proposed Compensation:<br/>Salary<br/>Bonus<br/>Deferred compensation<br/>Fringe benefits<br/>(excluding Sec.132 fringes)<br/>Liability insurance premiums<br/>Foregone interest on loans<br/>Other</li> <li>5. Comparability data relied upon (e.g., association survey, phone inquiries, etc.)<br/><b>Provide four instances of comparability data, include the following information:</b><br/>Source and Type<br/>Salary<br/>Bonus<br/>Deferred compensation<br/>Fringe benefits<br/>(excluding Sec.132 fringes)<br/>Liability insurance premiums<br/>Foregone interest on loans<br/>Other</li> <li>6. Total proposed compensation</li> <li>7. Maximum total compensation per comparability data</li> </ol> | <ol style="list-style-type: none"> <li>8. Compensation package approved by authorized body:<br/>Salary<br/>Bonus<br/>Deferred compensation<br/>Fringe benefits<br/>(list, excluding Sec. 132 fringes)<br/>Liability insurance premiums<br/>Foregone interest on loans<br/>Other</li> <li>9. Date compensation approved by authorized body</li> <li>10. Members of the authorized body present (indicate with X if voted in favor)</li> <li>11. Comparability data relied upon by approving body and how data was obtained</li> <li>12. Names of and actions (if any) by members of authorized body having conflict of interest</li> <li>13. Date this documentation was prepared (must be complete by later of next meeting of authorized body, or 60 days after authorized body approved compensation)</li> <li>14. Office or file where comparability data kept</li> <li>15. Date of approval of this documentation by board (must be within reasonable time after preparation of documentation above)</li> </ol> |
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