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Spotlight on Exempt Organizations: Intermediate Sanctions for Excess Benefit Transactions

Exempt organizations are favored under the Internal Revenue Code (Code) with the privilege of not being required to pay federal income taxes as long as the organization complies with the filing, disclosure and other requirements imposed by the Code, the Treasury Regulations and rulings from the Internal Revenue Service. Those requirements can vary depending upon the type of organization exempt from tax under Section 501(a) of the Code.

The purpose of this Alert is to focus upon the undue influence prohibition applicable to both charitable organizations exempt under Code Section 501(c)(3) and civic leagues exempt under Section 501(c)(4). Violating this prohibition creates exposure for substantial tax consequences even if the organization's exempt status is not revoked.

Background

In 1996, as part of the Taxpayer Bill of Rights, Congress added Section 4958 to the Code. That Section provides for "intermediate sanctions" that may be imposed when a Section 501(c)(3) or Section 501(c)(4) organizations engage in an "excess benefit transaction" with a "disqualified person." For this purpose a "disqualified person" is a person in a position to exercise substantial influence over the organization, certain family members and certain controlled entities. Organization managers include directors, trustees and officers of the tax exempt organization.

An "excess benefit transaction" is a transaction in which a disqualified person receives an economic benefit from a Section 501(c)(3) or 501(c)(4) organization that exceeds the value of the consideration received by the organization. Where an organization is a party to an excess benefit transaction, the Service may revoke its exempt status; however, in some instances a revocation may be a disproportionate penalty for the amount of private inurement and would otherwise prejudice the persons for whose benefit the organization was created. Thus, the Service may impose immediate sanctions in lieu of (or possibly in addition to) revocation of an organization's exempt status.

Consequences

Additional Tax. The consequences of engaging in an excess benefit transaction are the following intermediate sanctions:

- i. On the disqualified person -- the initial tax is 25% of the excess benefit.
- ii. On the managers who know that a transaction is an excess benefit transaction -- in an amount equal to 10% of the amount involved, up to \$20,000.
- iii. If the excess benefit transaction is not corrected -- an additional tax of 200% of the amount of the excess benefit.

The intermediate sanctions apply not only to organizations presently described in Sections 501(c)(3) and (4) but also to organizations which were so described at any time during the five-year period ending on the date of the excess benefit transaction. The apparent reason for this rule is to prevent organizations from converting to taxable status or otherwise engaging in an action that might jeopardize continued entitlement to exemption in order to avoid application of the Section 4958 excise taxes. To further that rule, Treasury Regulation Section 53.4958-2(a)(1) provides that the determination as to an organization's exempt status is to be made without regard to an excess benefit.

Potential Safe Harbors. Given the severity of the penalties that may be imposed and the potentially subjective nature of an excess benefit transaction, it would behoove organizations to qualify for the "rebuttable presumption" safe harbor provisions of Treasury Regulation Section 53.4958-6. The requirements for that rebuttable presumption safe harbor are as follows:

- i. The compensation arrangement (such as, for example, with executive management of the organization) or the terms of the property transfer are approved in advance by an authorized body of the organization;
- ii. The authorized body obtained and relied on appropriate data as to comparability prior to making its

- determination; and
- iii. The authorized body adequately documented the basis of its determination concurrently with making that determination.

If the three requirements set forth above are satisfied so as to establish the "rebuttable presumption," the IRS may rebut such presumption only if the Service develops sufficient evidence to contradict the probative value of the comparability data relied on by the organization's authorized body (see discussion below). With respect to any fixed payment, rebuttal evidence is limited to evidence relating to facts and circumstances existing on the date the parties entered into the contract. With respect to all other payments, rebuttal evidence may include facts and circumstances up to and including the date of payment.

Authorized Body. An authorized body means the governing body, a committee thereof or, to the extent permitted by local law, other parties authorized by the governing body to act on the organization's behalf by following procedures specified by the governing body. An individual is not included on the authorized body if that person meets with the other members only to answer questions and otherwise is excused from the meeting and is not present during the discussion and decision-making. An authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether a compensation arrangement is reasonable or a property transfer is at fair market value.

For a decision to be documented adequately, the record of the authorized body must note:

- i. The terms of the transaction that was approved and the date it was approved;
- ii. The members of the authorized body who were present during discussion and those who voted on the transaction;
- iii. The comparability data obtained and relied upon by the authorized body and how the data was obtained; and
- iv. Any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction.

The higher the level of compensation, the greater is the duty of care of the organization's governing body entrusted with making compensation recommendations. For executive level positions, consideration should be given to retaining the services of independent consultants. For many types of positions, e.g. university positions, published data should be available. In addition, for organizations required to file IRS Form 990, reference should be made to compensation data disclosed in the Form 990 filed by other comparable organizations.

Employment Contracts. In general, the rebuttable presumption with respect to non-fixed payments does not apply until amounts are determined. The exception to this rule is for employment contracts with a disqualified person if:

- i. Prior to approving the contract, the authorized body obtains appropriate comparability data indicating that a fixed payment of up to a certain amount would represent reasonable compensation;
- ii. The maximum amount payable does not exceed the amount referred to above; and
- iii. The other requirements for the rebuttable presumption of reasonableness are satisfied.

Employee benefits, such as health insurance and retirement plan contributions, are subject to the same scrutiny as salaries. In addition, expense reimbursements must be substantiated and qualify as reimbursement under an accountable plan. Unsubstantiated expense reimbursements are automatically excess benefit transactions if not treated as taxable wage income and will result in all expense reimbursements being deemed to be made under a nonaccountable plan.

For all but the smallest organizations, consideration should be given to having a compensation committee which makes initial recommendations as to the overall compensation package, and then submits those recommendations to the full board for consideration and decision making.

Summary

Intermediate sanctions resulting from excess benefit transactions can produce significant financial exposure for a Section 501(c)(3) and Section 501(c)(4) organization and its managers, as well as for the disqualified person. The adverse economic impact of such sanctions is amplified significantly if the excess benefit transaction is not corrected. Identification of possible excess benefit transactions and implementation of the associated steps so as to seek protection from the intermediate sanctions under the rebuttable presumption safe harbor provisions, certainly adds additional administrative and operating burdens on these exempt organizations and their staff. However, those requirements for safe harbor qualification represent yet another due diligence checklist for upgrading the organization's management and governance credentials.

Should you have any questions regarding excess benefit transactions, or any other requirements applicable to the operation of exempt organizations, please do not hesitate to contact the following attorneys within the Firm's [Tax Department](#):

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