

*What You Should Know About
Intermediate Sanctions*

*For Board Members and
Prospective Board Members
of Section 501(c)(3) and 501(c)(4) Organizations*

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Introduction



In 1996, the Taxpayer Bill of Rights 2 added to the Internal Revenue Code a series of excise taxes, known as “intermediate sanctions,” that can be imposed directly on “insiders” of section 501(c)(3) and 501(c)(4) organizations. On January 22, 2002, the IRS issued final regulations implementing the intermediate sanctions statutory scheme.

This booklet is intended to provide a brief introduction to intermediate sanctions for Board members and other individuals who are potentially subject to the taxes.



What Are Intermediate Sanctions?

“Intermediate sanctions” are a series of federal excise taxes imposed on “insiders” of section 501(c)(3) and section 501(c)(4) organizations. The excise taxes, found in the Internal Revenue Code at section 4958, were enacted into law in July 1996, and final regulations were issued in January 2002.

The law does not apply to section 501(c)(3) private foundations, which are subject to a separate regime. Generally, private foundations are charitable organizations controlled and funded by a relatively small group of individuals or corporations. Additionally, the law generally does not apply to governmental entities or affiliates of governmental entities.

What Impact Can Intermediate Sanctions Have on Me?

Intermediate sanctions impose a *personal liability* on organization “insiders,” known in the law as “disqualified persons.” In essence, if an insider – or certain related parties – directly or indirectly receives an “excess benefit” from a section 501(c)(3) or 501(c)(4) organizations, the insider:

- Is personally liable for a first-tier excise tax equal to 25 percent of the excess benefit, and
- Must “correct” the excess benefit (*i.e.*, repay the excess benefit to the organization).

Failure to repay the excess benefit can result in a second-tier excise tax on the insider equal to 200 percent of the excess benefit.

In addition, individuals who are “organization managers” – including Board members – are subject to an excise tax equal to 10 percent of the excess benefit for willful and knowing participation in an excess benefit transaction. Thus, even if you or a related party did not derive an excess benefit, you may be subject to the tax as an organization manager. The tax on organization managers is a joint and several liability of all managers involved, and is limited to \$10,000 per transaction.

The excise taxes can be abated if it is established that the transaction was due to reasonable cause and not to willful neglect, and the excess benefit is timely corrected.

What Impact Can Intermediate Sanctions Have on My Organization?

Although the excise taxes themselves are personal liabilities of the insider or organization manager, an exempt organization is required to disclose transactions subject to intermediate sanctions on its Form 990. Disclosure includes:

- The names of the persons involved;



What You Should Know About Intermediate Sanctions



- A detailed description of the transactions giving rise to the intermediate sanctions tax;
- Whether or not the excess benefit transaction was corrected; and
- The amount of excise taxes paid.

Form 990 is a publicly available document that is frequently reviewed by the press, regulators, donors, and others. It is expected that disclosure of an intermediate sanctions assessment would cause considerable embarrassment to the organization and the persons involved. Moreover, the imposition of a penalty can sometimes have a significant adverse impact on the organization's ability to raise funds from major donors and the public at large.

How Do I Know Whether I am an Insider?

In general, the law defines an insider (a "disqualified person") as any person who, during the last five years, was "in a position to exercise substantial influence over the affairs of the organization." The regulations define categories of persons who are deemed to be insiders *per se*, those who are deemed not to be insiders, and those who may or may not be insiders depending on whether the "facts and circumstances" show that the person has substantial influence over the affairs of the organization. *Per se* insiders include, among others:

- Voting board members;
- President, chief executive officer, or chief operating officer; and
- Treasurer or chief financial officer.

Additionally, certain related parties may also be considered insiders for this purpose, including family members and businesses in which an insider (or group of insiders) has more than a 35 percent interest.

Note that a company can be an insider, even if it is not controlled by an insider. For example, a management company can be an insider with respect to an organization if it has ultimate responsibility for supervising the management of the organization and its day-to-day operations.

What Kinds of Transactions are Subject to Intermediate Sanctions?

The law encompasses any kind of transaction in which an insider receives an economic benefit from an exempt organization that exceeds the fair market value of the consideration the organization receives in return. The law also encompasses a transaction in which the economic benefit is provided to the insider indirectly – *i.e.*, through an entity controlled by the organization or through an intermediary. These transactions are referred to as "excess benefit transactions."



Examples of the law's breadth include:

An insider who receives compensation from the organization that exceeds the fair value of the services rendered;

- An insider who buys property from the organization at less than fair value or sells property to the organization at greater than fair value;
- An insider who leases property from the organization at less than fair value or leases property to the organization at greater than fair value;
- An insider who borrows money from the organization on less than fair value terms or lends money to the organization on greater than fair value terms; and
- An insider who engages in one of the above transactions with an entity controlled by the organization.

These are illustrative examples only. The law encompasses any transaction in which an insider receives an "excess benefit."

The regulations list certain types of economic benefits that will be disregarded when considering whether an insider has received an excess benefit, including, among others:

- Most nontaxable fringe benefits; and
- Expense reimbursements paid pursuant to an accountable plan (such as paying reasonable expenses for members of an organization's governing body to attend meetings).

The regulations also provide an "initial contract" exception. Under this exception, intermediate sanctions do not apply to a fixed payment for services or property made pursuant to a contract with a person who is not an insider with respect to the organization prior to entering into the contract. There must be a binding written contract, and the payments under the contract must either be specified in the contract or determined by a nondiscretionary formula specified in the contract.

Other Board Actions: Board Members as "Organizational Managers"

In addition to being insiders, Board members are "organization managers." In their capacity as organization managers, Board members may be called upon to approve transactions between the organization and other insiders. For example, Board members are often responsible for approving compensation paid to senior officers of the organization. If those officers are themselves considered insiders (which is likely), and a Board member approves compensation knowing that it is unreasonably high, the Board member may be subject to the 10 percent excise tax on organization managers. The tax also applies to other Board-approved transactions that do not involve compensation, such as the purchase, sale, or licensing of assets.



A Board member potentially could be liable for both the excise tax applicable to insiders and the excise tax applicable to organization managers, if the Board member participates in a transaction directly and also participates as an organization manager. For example, if a Board member purchased property from the organization for less than its fair market value and also participated in the approval of the sale on behalf of the organization, the Board member could be liable for both taxes.

The regulations contain a significant protection for organization managers by providing that an organization manager's participation in a potential excess benefit transaction will not be considered "knowing" if the organization manager relies on a reasoned written opinion of an appropriate professional advising the organization to proceed with the transaction. In addition to legal counsel, an "appropriate professional" for this purpose includes a CPA or accounting firm with expertise regarding the relevant tax matters, and a valuation expert who meets certain requirements.

What Other Protection Is Available?

The regulations provide a "rebuttable presumption" that a compensation arrangement is reasonable or a property transaction is at fair market value (and hence, not an excess benefit transaction) if certain procedures are followed.

In general, to qualify for the rebuttable presumption:

- The compensation arrangement or property transaction must be approved in advance by an independent Board or authorized committee of the Board;
- The Board or committee must obtain and rely upon appropriate comparability data (e.g., compensation studies or third-party appraisals) in approving the arrangement or transaction; and
- The Board or committee must contemporaneously document the basis for its approval in light of the comparability data, performance evaluations, and similar information.

Detailed procedures for obtaining the rebuttable presumption of reasonableness are provided in the regulations. If the procedures are followed, the intermediate sanctions excise taxes can be imposed only if the IRS develops sufficient contrary evidence to rebut the comparability data relied upon by the organization. As a practical matter, the IRS would likely have to invest considerable extra effort to impose the taxes.

What about Indemnification and Insurance?

While organizations may indemnify Board members against the intermediate sanctions excise taxes, such indemnification generally must be included in the Board member's compensation for purposes of determining whether the compensation is reasonable. If the indemnification amount, when added to other payments to the Board member, results in payment of more than reasonable compensation for the Board member's services to the organization, the indemnification payment



Itself would constitute an excess benefit. Thus, the Board member could be subject to an excise tax on the indemnification and be required to restore the payment to the organization.

Some Examples, Please

The following examples are intended to illustrate situations under which the intermediate sanctions excise taxes may be imposed:

- *Legal Services:* A Board member who is also an attorney performs legal services for the organization. During the year, the attorney bills the organization \$100,000 for legal services. It is later determined that the fair market value of those services was \$50,000. The Board member is subject to a first-tier excise tax of \$12,500 (25% x \$50,000 excess benefit) and must repay the \$50,000 excess benefit, plus interest. Failure to repay the excess benefit may result in a second-tier excise tax equal to \$100,000 (200% x \$50,000 excess benefit).
- *Lease:* A Board member rents office space from the organization for \$100,000 per year. It is later determined that fair rental value is \$200,000 per year. The Board member is subject to a first-tier tax of \$25,000 (25% x \$100,000 excess benefit), and must repay \$100,000 plus interest to the organization. Failure to repay may result in a second-tier tax of \$200,000 (200% x \$100,000 excess benefit). If the Board member also participated in the Board's decision to enter into the lease, the Board member also could be liable for an additional tax of \$10,000 (10% x \$100,000 excess benefit) as organization manager.
- *Purchase from Related Party:* A Board member owns more than 35 percent of an office supply corporation. The corporation has a contract to supply all of the organization's paper needs. During the year, the corporation charges the organization \$100,000 for paper, but it is later determined that the fair market value of the paper is \$50,000. Because the corporation is more than 35 percent owned by the Board member, it is considered an insider. The corporation is subject to a first-tier excise tax of \$12,500 (25% x \$50,000 excess benefit), and must repay \$50,000 plus interest to the organization. Failure to repay may result in a second-tier tax equal to \$100,000 (200% x \$50,000 excess benefit).
- *President's Compensation:* A Board member is on the committee that approves the compensation of the organization's new president. The Board member knows that the fair market value of the president's services does not exceed \$150,000. Nevertheless, the Board member votes to approve setting the president's compensation at \$250,000. The Board member may be subject to an excise tax of \$10,000 (10% x \$100,000 excess benefit) as an organization manager. Also, the president would be subject to an excise tax of \$25,000 (25% x \$100,000 excess benefit) and would be required to repay the \$100,000 excess benefit, plus interest, to the organization in order to avoid the imposition of an additional tax of \$200,000 (200% x \$100,000 excess benefit).



Protecting Your Organization

Board members, key executives, and organizations can reduce the risk presented by intermediate sanctions through a series of well-designed policies and procedures. Existing policies – such as those governing conflicts of interest – may offer some protection.

Organizations should consider implementing processes to identify insiders, to provide a means for those insiders to disclose related parties, to track transactions with insiders, to permit insiders to benefit from the “rebuttable presumption” process, and to ensure correct tax reporting for transactions potentially subject to the tax. Because of the large number of potential “insiders” subject to the tax, (including related parties), however, an intermediate sanctions risk management program should also include an educational component. Board members and other organizational “insiders” need to be reminded periodically of the mechanics of the law and the ways they can reduce their exposure.

For assistance in implementing an intermediate sanctions risk management program or evaluating existing procedures, please contact:

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