

Intermediate Sanctions

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by
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Intermediate Sanctions Rules

As a result of the insertion of new Section 4958 to the Internal Revenue Code in 1996, the Internal Revenue Service has, in the appropriate cases, the ability to impose “intermediate sanctions,” short of revocation of exempt status, where a tax-exempt organization has engaged in transactions conferring inappropriate benefits on persons with a special relationship to that organization. Such sanctions witness the imposition of excise taxes on “disqualified persons” and “organizational managers” engaging in “excess benefit transactions” with a Section 501(c)(3) or (4) organization, other than a private foundation. An “excess benefit transaction” is one which bestows upon its recipient an economic reward greater than the benefit received in turn by the organization.

A “disqualified person” is one¹ “in a position to exercise substantial influence over the affairs of the organization.”² Officially defined to include members of the organization’s board of trustees or directors,³ the term specifically includes CEO’s, presidents, CFO’s, COO’s, and treasurers.⁴ Otherwise, a “facts and circumstances” analysis must be undertaken to determine whether a tax-exempt officer or employee wields “substantial influence.”⁵ Relevant factors include whether the individual “has or shares authority to control or determine a substantial portion of the organization’s capital expenditures, operating budget, or compensation for employees” or “manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole.”⁶ Nevertheless, an employee who receives less than \$115,000 per year⁷ in total compensation is deemed not to exercise substantial influence over the affairs of the organization, unless he or she is defined as a disqualified person or whose responsibilities put him or her in a position to substantially influence the organization.

For his or her part, an “organization manager” is a trustee, director, or officer of a tax-exempt organization or someone with similar powers or responsibilities.⁸ This represents a broader definition than that for a disqualified person, and it is possible for a person to be both a disqualified person and an organization manager and be subject to taxes as each.

Employee compensation is subject to scrutiny as an “excess benefit transaction.” Such

¹ While the term “person” can include any form of legal person, such as a corporation, for our purposes we shall use the word in the sense of a human individual.

² Internal Revenue Code §4958(f)(1)(A).

³ IRC Regs. §53.4958-3(b)(2)(i).

⁴ Regs. §§53.4958-3(c)(2) and (3).

⁵ Reg. §3.4958-3(e)(1).

⁶ Reg. §3.4958-3(e)(2).

⁷ For 2012. This limit is subject to annual adjustment under the provisions of IRC §414(q)(1)(B)(i) as the threshold for definition of a “highly compensated employee.”

⁸ Reg. §3.4958-3(d)(2).

compensation includes:

- All forms of cash and non-cash compensation, including salary, fees, bonuses, severance payments, and certain deferred and non-cash compensation arrangements;
- The payment of certain liability insurance premiums; and
- All other compensatory benefits, whether or not included in gross income for income tax purposes⁹

In the event of an excess benefit to a disqualified person, the penalties faced by the disqualified person involve:

1. payment in cash or equivalents equal to the sum of the excess benefit, plus interest at a rate at or above the applicable federal rate, compounded annually; and
2. payment of an excise tax of 25% of the excess benefit by the earlier of a notice of deficiency or assessment of the excise tax; and
3. failing timely payment of the excise tax penalty, payment of an additional tax of 200% of the excess benefit.

When the excise tax is imposed upon a disqualified person, a tax in the amount of 10% of the excess benefit is also imposed upon any organization managers who knowingly participated in the excess benefit transaction unless this action was not willful and was due to reasonable cause. This tax is capped at \$20,000 per incident for all participating managers.¹⁰

As noted earlier, a disqualified person could also be an organizational manager. To illustrate, if the president of a tax-exempt received an excess benefit and participated as a trustee in a board transaction to approve it, he or she could be liable for:

Payment of the excess benefit with interest
+ 25% (of the excess benefit) excise tax
+ 200% (of the excess benefit) excise tax
+ 10% (of the excess benefit) excise tax, up to \$20,000

However, IRS regulations provide a “safe harbor” under which a compensation arrangement is presumed to be reasonable, provided that certain conditions are met. Thus, if the tax-exempt can demonstrate that it exercised care and prudence in the process relating to a transaction with a disqualified person, then the burden shifts to the Internal Revenue Service to

⁹ Reg. §53.4958-4(b)(1)(ii)(B). We offer a cautionary note that a tax-exempt take care to document its intent to treat what it deems compensation as consideration for the performance of services, e.g., through a pay statement or Form W-2. Otherwise, there is the risk that it may appear that compensation was provided for no consideration at all, thereby giving rise to a *de facto* excess benefit transaction.

¹⁰ The \$20,000 maximum is spread among all of the organization managers participating, under joint and several liability. This was increased from \$10,000 under the Pension Protection Act of 2006.

show that the transaction is unreasonable.¹¹ These steps must be carried out to create the presumption of reasonableness:

- the compensation arrangement must be approved in advance by an authorized body or committee comprised entirely of individuals without a conflict of interest with respect to the arrangement;
- the authorized body or committee must obtain and rely upon appropriate comparability data prior to making its decision; and
- the authorized body or committee must adequately document the basis for its determination concurrently with making the determination.¹²

It is the second of these, the preparation of “appropriate comparability data,” that is at the heart of the services provided by the Organizational Consulting Group to its affected nonprofit clientele. Here, we may take into consideration:

- ✓ compensation levels paid by similarly situated organizations, *tax-exempt and for-profit*, for functionally comparable positions;¹³
- ✓ the availability of similar services in the geographic area;
- ✓ current compensation surveys compiled by independent firms; and
- ✓ actual written offers from similar institutions competing for the services of the disqualified person.

OCG’s intermediate sanctions analysis will center upon these questions such as these:

- ❖ *Is this incumbent a disqualified person?*
- ❖ *If so, what is the appropriate total compensation for the position?*

We hope this brief introduction will prove useful to your understanding of a complex issue. Should you have any further questions or if the Organizational Consulting Group can assist your organization with its compensation planning, please contact a representative of OCG.

¹¹ Reg. §53.4958-6(b).

¹² Reg. §53.4958-6(a).

¹³ Reg. §53.4958-4(b)(1)(ii)(A).