

Section 501(c)(3) Organizations, Intermediate Sanctions, and Reasonable Compensation: A Primer

"Intermediate sanctions" are federal taxes that can be imposed personally on the directors and top officials of a section 501(c)(3) organization when an executive or other influential insider is paid too much by the charity, and they can also be imposed on the insider who receives the excessive compensation. Directors and top officials need to be familiar with the intermediate sanctions and understand how to insure that they do not become subject to them.

Executive Summary

- Every section 501(c)(3) organization (except for private foundations and certain government entities) is subject to the Internal Revenue Code provisions creating intermediate sanctions.
 - Even small organizations are covered.
 - Section 501(c)(4) organizations are also covered.
- The intermediate sanctions are federal penalty excise taxes imposed on individuals who receive, or knowingly approve, compensation arrangements in which an influential insider gets too much compensation (including non-cash benefits and perquisites) from the charity.
 - The influential insider, called a "disqualified person," must return the excess compensation to the charity and pay a tax of 25% (with a possible additional 200% tax) of the amount of the excess benefit.
 - Directors or executives who knowingly approve the payment of the excessive compensation are jointly subject to a tax of 10% of the amount of the excess compensation.
- IRS Regulations outline a process that a Board of Directors can follow to reduce its exposure to the intermediate sanctions.
 - The Board of Directors or other authorized body must approve the compensation in advance. Only individuals who do not have a conflict of interest may participate in the decision.

- The Board of Directors must obtain and rely on appropriate objective data on comparability prior to making the decision on compensation.
 - A section 501(c)(3) organization with less than \$1,000,000 of annual gross receipts is not required to obtain as much objective data on comparability as a larger organization.
- The Board of Directors must adequately document its actions.
- Every Board of Directors should consider utilizing this procedure, which creates a rebuttable presumption that the compensation is reasonable, when the Board sets compensation for top executives and other insiders.
- A Board of Directors can also reduce its exposure by obtaining a written opinion of an appropriate professional that the compensation is reasonable.

Discussion

Inurement and Private Benefit. Section 501(c)(3) of the Internal Revenue Code explicitly provides that a corporation, trust, or association may qualify for exemption as a charitable or educational organization only if, among other things, "no part of its net earnings inures to the benefit" of any private individual.

- "Inurement" occurs when an influential insider (e.g., a director, a top manager, or a major donor) gets a benefit or something of value from the organization and does not give fair value in return.
- "Private benefit" occurs when an individual (not an insider) receives more than an incidental benefit from a transaction or arrangement with the organization and the individual has not given fair value in return.

Intermediate Sanctions Generally. Prior to the Taxpayer Bill of Rights 2, the IRS's only weapon against inurement was revocation of an organization's exemption. This was rarely used by the IRS for obvious reasons. Effective for transactions occurring on or after September 14, 1995, however, section 4958 of the Code imposes "intermediate sanctions", or federal penalty excise taxes, on individuals who receive too much from an organization or who knowingly approve the compensation arrangement or transaction that confers the private inurement or excessive benefits.

- Thus, instead of penalizing the organization, intermediate sanctions impose personal excise tax liability on the individuals who actually receive excessively

rich economic benefits from a section 501(c)(3) organization or who knowingly approve such benefits.

- The sanctions apply in cases of excessive compensation as well as other transactions in which an insider receives an economic value greater than the value provided.
 - Covered transactions include sales of assets or loans that are not made on commercially reasonable terms.
 - Although the IRS has not yet issued guidance on this subject, the sanctions will also apply to certain revenue sharing arrangements.
- **Excise Tax.** The excise tax is applied to the "excess benefit," or the amount in excess of the actual fair market value of the service. For example, if a charity gives compensation of \$100,000 annually to its president (who is an insider), and reasonable compensation is really \$75,000, the "excess benefit" is \$25,000.
 - For the president, or "disqualified person," who benefits, the initial tax is 25% of the excess benefit. If the excess benefit is not corrected/paid back in a certain period, the president is subject to an additional tax of 200% of the excess benefit. For example, if the excess benefit was \$25,000, the potential excise tax on the president is \$56,250 (\$6,250 + \$50,000).
 - An "organization manager" (including a director) who knowingly participates in approval of the arrangement is subject to a 10% excise tax up to a maximum of \$10,000. Thus, if the excess benefit is \$25,000, the organization manager potentially is responsible for a \$2,500 excise tax. This liability is shared jointly among all organization managers who knowingly participate.
- **Disqualified Person.** The statutory term for an insider is "disqualified person" or "DP", which is defined broadly to include:
 - Any person who at any time in the five years before the transaction was in a position to exercise substantial influence over the affairs of the organization. The final regulations published January 23, 2002, provide that this category includes, among others, the president, the chief executive officer, the chief operating officer, and voting members of the governing board;
 - A member of the family of such a person; and

- An entity (corporation, partnership, trust, etc.) in which such a person (or family member) controls 35%.

The Regulations apply a "facts and circumstances" test to determine the status of other individuals.

Rebuttable Presumption of Reasonable Compensation. The Regulations establish an important procedure that will create a "rebuttable presumption" that a compensation arrangement is reasonable. Following the procedure ordinarily protects a director who approves compensation from being subject to personal excise tax liability if the compensation is later found to be excessive because the director will not have "knowingly" approved excessive compensation.

The presumption will be established if the following conditions are satisfied.

- **Advance Approval.** The compensation is approved in advance by an authorized body of the tax-exempt organization composed entirely of individuals who do not have a conflict of interest.
 - The Board of Directors is an authorized body. A board committee can also be an authorized body as long as state law permits the committee to act on behalf of the board.
 - A director or board committee member with a conflict of interest should not participate in any way in the process, and the minutes should document that fact.
 - **Compensation Committees.** Tax exempt organizations are increasingly establishing formal compensation committees to set compensation for top executives. The composition of these committees must be carefully structured and monitored to insure that the requirements of the "rebuttable presumption" are met.
- **Comparability Data.** The authorized body must obtain and rely upon appropriate data as to comparability prior to making its determination. Appropriate data includes:
 - compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions;
 - current compensation surveys compiled by independent firms; and

- actual written offers from similar institutions competing for the services of the disqualified person.

A small charity with annual gross receipts of less than \$1,000,000 is required to obtain less data.

- **Documentation.** The authorized body must adequately document the basis for its determination when it makes that determination. The written or electronic records must note:
 - the terms of the arrangement and the date approved;
 - the members of the authorized body present during discussion of the arrangement and those who vote on it;
 - the comparability data used and how it was obtained; and
 - what actions are taken by anyone who is a member of the authorized body but who has a conflict of interest.

If the three requirements are satisfied, then the IRS may rebut the presumption only if it develops enough contrary evidence to rebut the probative value of the comparability data used.

Written Opinion. A Board of Directors can also reduce its exposure by fully disclosing all facts to an appropriate professional and obtaining a reasoned written opinion with respect to elements of the transaction or arrangement within that professional's expertise.

- Obtaining such a written opinion reduces the possibility that a director will be subject to intermediate sanctions because the director will not have "knowingly" approved excessive compensation.
- Legal counsel (including in-house counsel), CPAs or accounting firms with expertise in the relevant tax matters, and certain independent valuation experts can issue written opinions.

Defining Compensation. Compensation includes all forms of cash and non-cash compensation, including salary, fees, bonuses, severance payments and certain non-cash compensation.

- Special rules define when benefits provided under a qualified pension or profit-sharing plan are deemed paid.

- Special rules also govern other compensation-related issues including incentive compensation, and care must be exercised to comply with them.
- Some incidental compensation may be excluded.

Documenting Compensation. Contemporaneous documentation of economic benefits as compensation or wages is important.

- **Automatic Excess Benefit Transactions.** Giving a benefit to an employee without contemporaneously documenting that the benefit is compensation results in an “automatic excess benefit transaction” subject to disclosure and penalty excess taxes.
 - The undocumented benefit or payment is an automatic excess benefit transaction even if total compensation, including the undocumented benefit, is reasonable.
 - If the organization had reasonable cause for its failure to document the benefit, assuming that total compensation is otherwise reasonable, the benefit will not constitute an automatic excess benefit transaction.
- Timely reporting by an organization of a benefit on Form 990, Form W-2 or Form 1099 documents the fact that a benefit is compensation.
- An approved written employment contract executed on or before the date of payment of a benefit may also serve as documentation.

Initial Employment Contract. Fixed compensation payments made to a person under an initial employment agreement are not subject to intermediate sanctions as long as the person does not already have another preexisting relationship that makes him a disqualified person.

- An organization may still want to use the rebuttable presumption process to set initial compensation because an initial contract will set the compensation base for subsequent years.

The regulations address a number of other technical issues, and a Board of Directors should obtain specific advice relevant to any proposed compensation arrangement it is going to review.

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This document is intended for educational and informational purposes and should not be considered legal advice. If you have any questions or would like to discuss a particular situation, please communicate with Melinda A. Agsten or your regular Wiggin and Dana lawyer, including the following members of the Tax Exempt Organizations Practice Group:

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