

# Intermediate Sanctions and the Rebuttable Presumption

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## **GOVERNANCE AND “BEST PRACTICES”**

Charities play a significant role in our society. They provide services and grants in a wide variety of areas that are of importance to the community, ranging from hospitals to educational institutions to museums to organizations dedicated to assisting those in need. The purpose – or mission – of these organizations drive the activities it carries out and the board of directors is responsible for overseeing management to ensure that this occurs.

Governance, transparency and accountability are critical issues for all charities. Effective governance, transparency and accountability leads to increased public trust in the organization and a greater willingness to donate funds and services. The ultimate goals should be an active and engaged board. In this respect, the experience of boards in the for-profit world provides a useful point of comparison. Boards of for-profit organizations have worked to restore public confidence and increase investment in the wake of several highly public governance failures. The steps taken by boards of for-profit organizations – including those required by reforms embodied in the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”) and related rules and regulations – have led to increased board engagement. Boards of charities may wish to embrace these measures that have become “best practices;” although not required by law, the IRS has articulated “good governance” standards for all tax-exempt organizations.

### **I. INTERMEDIATE SANCTIONS AND THE REBUTTABLE PRESUMPTION**

#### **A. The Bottom Line for Board Members**

Members of governing boards of charitable organizations described in Internal Revenue Code Section 501(c)(3) have a duty to assure that the organization does not provide certain inside parties (i.e., directors and officers) more than an arm’s length, fair market value compensation, contract terms and/or fringe benefits. The IRS imposes severe penalties on the recipient of excessive compensation, and also imposes personal financial penalties on directors or trustees when it finds an “excess benefit” transaction.

Any paid contracts, salary or benefit adjustments or bonus decisions may expose a board to these penalties. Therefore, a board will want to consider steps to assure that the compensation and benefit levels for insiders are well within allowable ranges and contain no excess benefits. By having a board follow certain procedures in setting any insider compensation and approving the contract, it can largely eliminate a board members’ personal penalty exposure.

#### **B. Intermediate Sanctions – Overview**

Excise taxes are imposed on certain “disqualified persons” who improperly benefit from an “excess benefit transaction” involving the organization. Excise taxes are also imposed on “organization managers” who participate in an excess benefit transaction knowing that it is such a transaction, unless the participation is not willful and is due to reasonable cause.

These penalties are commonly referred to as “intermediate sanctions.” Before these provisions became effective in 1995, the IRS’s only tool when it encountered excess benefit transactions was to revoke the tax exempt status of a Code Section 501(c)(3) organization. It had no available sanction other than what was considered to be tantamount to the “death penalty” for a charity.

The scandal involving the compensation and benefits of William Aramony, President of United Way of America, and the unwillingness of the IRS to revoke United Way's exempt status because of the Aramony transactions, persuaded Congress that intermediate sanctions were needed. Accordingly, it enacted what is now Code Section 4958, entitled "Taxes On Excess Benefit Transactions."

### C. Taxes on Disqualified Persons

An initial tax is imposed, for each excess benefit transaction, on the disqualified persons. The tax is equal to 25% of the "excess benefit" from the transaction. An additional tax is imposed in any case in which an initial 25% tax is imposed and the excess benefit involved in the transaction is not corrected within the correction period. The additional tax is equal to 200% of the excess benefit involved.

#### (1) Who are Disqualified Persons?

A "**disqualified person**", with respect to any transaction, is any person who was in a position to exercise substantial influence over the affairs of the organization at any time during the five-year period ending on the date of the excess benefit transaction. A disqualified person would include, among others, any of the following:

- any board member;
- any person who, regardless of title, has ultimate responsibility for implementing the decisions of a board or for supervising the management, administration, or operation of the organization, such as the organization's president, chief executive officer (CEO), or chief operating officer (COO);
- any person who, regardless of title, has ultimate responsibility for managing the organization's finances, such as the organization's treasurer or chief financial officer (CFO);
- any other person in a position to exercise substantial influence during the applicable period, unless such person is an employee of the organization who:
  - receives economic benefits from the organization of less than \$90,000;
  - is not defined in 1, 2 or 3 above; and
  - is not a substantial contributor to the organization;
- any member of the family of a person who is a disqualified person; and
- any entity in which a disqualified person holds a 35% or greater interest.

#### (2) What is an Excess Benefit Transaction?

An "**excess benefit transaction**" is any transaction in which an economic benefit is provided by the 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 (including the performance

of services) that the organization received for providing the benefit. An “*excess benefit*” is the excess referred to in the above definition of excess benefit transaction. The most common form of an excess benefit transaction occurs when an organization pays a disqualified person unreasonable compensation with respect to the services rendered.

Compensation is reasonable if it is in an amount that would ordinarily be paid for like services by like enterprises under similar circumstances. With respect to excess or unreasonable compensation, the most critical concept is that all of the consideration for performance of services given to an individual needs to be included in determining whether the compensation is reasonable. Compensation includes all forms of cash and non-cash compensation, including salary, fees, bonuses, and severance payments. Compensation includes all other compensatory benefits, whether or not included in gross income for income tax purposes, including payments to welfare benefit plans, such as plans providing medical, dental, life insurance, severance pay, and disability benefits, and most taxable and nontaxable fringe benefits.

### (3) Rebuttable Presumption of Reasonableness – Fixed Payment Arrangements

If the following three conditions are satisfied, all payments under a fixed-payment compensation arrangement between the organization and a disqualified person are presumed to be reasonable:

- the compensation arrangement must be approved in advance by a board composed entirely of individuals who do not have a “conflict of interest” with respect to the compensation arrangement;
- a board must obtain and rely upon “appropriate data as to comparability” of compensation before making its determination; and
- a board must “adequately document” the basis for its determination concurrently with making that determination.

If the above three requirements are satisfied, then the Internal Revenue Service may rebut the presumption that so arises only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by a board.

A board member will not have a “*conflict of interest*” with respect to a compensation arrangement if such member:

- is neither a disqualified person economically benefiting from the compensation arrangement, nor is a member of the family of the disqualified person;
- is not in an employment relationship subject to the direction or control of any disqualified person economically benefiting from the compensation arrangement;
- does not receive compensation or other payments subject to approval by any disqualified person economically benefiting from the compensation arrangement;
- has no material financial interest affected by the compensation arrangement; and



- does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement where that disqualified person in turn has approved or will approve a transaction providing economic benefits to the member.

A board has “*appropriate data as to comparability*” if, given the knowledge and expertise of its members, it has information sufficient to determine whether the compensation arrangement in its entirety is reasonable. Relevant information as to comparability of compensation includes (but is not limited to):

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

There is a safe harbor for reviewing compensation arrangements available to small tax-exempt organizations, defined here as those with annual gross receipts (including contributions) of less than \$1 million. Under this safe harbor, a board of a smaller organization will be considered to have appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services. Although an organization’s budget may be too large to be eligible for this exception, it is important to note the implication that larger organizations such as the organization would logically be expected to obtain data from *more than* three comparable organizations to qualify for the rebuttable presumption.

Written or electronic records of a board approving the compensation arrangement must note all of the following for a decision to be “*documented adequately*”:

- the terms of the compensation arrangement that was approved and the date it was approved;
- the members of a board who were present during the debate on the transaction that was approved and those who voted on it;
- the comparability data obtained and relied upon by a board and how the data was obtained;
- any actions taken with respect to consideration of the transaction by anyone who is a member of a board but who had a conflict of interest with respect to the transaction; and
- if a board determines that reasonable compensation is higher or lower than the range of comparability data obtained, a board must record the basis for its determination.

#### (4) Rebuttable Presumption of Reasonableness – Non-Fixed Payment Arrangements

The rebuttable presumption of reasonableness arises, in the case of a payment that is not a fixed payment:

- only after the exact amount of the payment is determined, or
- a fixed formula for calculating the payment is specified, and
- the three requirements for the presumption are satisfied after that determination.

There is, however, a limited exception available for certain non-fixed payments subject to a cap. If a board approves an employment contract with a disqualified person that includes a non-fixed payment – such as a discretionary bonus – subject to a specified cap, a board may establish a rebuttable presumption with respect to the non-fixed payment at the time the employment contract is entered into if:

- before approving the contract, a board obtains appropriate comparability data indicating that a fixed payment of up to a certain amount to the particular disqualified person would represent reasonable compensation;
- the maximum amount payable under the contract, taking into account both fixed and non-fixed payments, does not exceed the amount referred to immediately above; and
- the other two requirements for the rebuttable presumption of reasonableness are satisfied.

#### D. Taxes on Organization Managers

In cases where an initial 25% tax has been imposed on disqualified persons, a tax is also imposed with respect to an excess benefit transaction on the organization managers who “participate” in the transaction “knowing” it to be an excess benefit transaction. The tax is equal to 10% of the excess benefit. However, the tax is not imposed where the organization manager’s participation was not “willful” and was due to “reasonable cause.”

##### (1) Who is an Organization Manager?

An “*organization manager*” is:

- any officer, director, or trustee of the organization; or
- any individual having powers similar to those of officers, directors or trustees of the organization, regardless of the individual’s title.

Under a special rule for certain committee members, an individual who is not an officer, director, or trustee, yet serves on a committee of a board that is attempting to invoke the rebuttable presumption of reasonableness based on the committee’s actions, is an organization manager for purposes of the 10% tax imposed on organization managers.

## (2) What is Knowing Willful Participation?

“**Participation**” includes silence or inaction on the part of an organization manager where the manager is under a duty to speak or act, as well as any affirmative action by the manager. However, a manager is not considered to have participated in an excess benefit transaction where the manager has opposed the transaction in a manner consistent with the fulfillment of the manager’s responsibilities to the organization.

An organization manager participates in a transaction “**knowingly**” only if the person:

- has actual knowledge of sufficient facts so that, based solely upon those facts, the transaction would be an excess benefit transaction;
- is aware that such an act under these circumstances may violate the intermediate sanction provisions; and
- negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the manager is in fact aware that it is such a transaction.

“Knowing” does not mean having reason to know. However, evidence tending to show that a manager has reason to know of a particular fact or particular rule is relevant in determining whether the manager had actual knowledge of the fact or rule.

Participation by an organization manager is “**willful**” if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. However, participation by an organization manager is not willful if the manager does not know that the transaction in which the manager is participating is an excess benefit transaction.

## (3) What is Reasonable Cause?

The participation by an organization manager is “**due to reasonable cause**” if the manager has exercised his responsibility on behalf of the organization with ordinary business care and prudence.

## (4) Safe Harbor – Reliance on Professional Advice

There is a safe harbor under which participation by an organization manager in a transaction will ordinarily not be subject to the 10% tax, even though the transaction is later held to be an excess benefit transaction. Specifically, an organization manager is ordinarily not considered to have knowingly participated in a transaction, to the extent that, after full disclosure of the factual situation to an appropriate professional, the organization manager relies on a reasoned written opinion of that professional regarding the elements of the transaction within the professional’s expertise. However, the absence of a written opinion of an appropriate professional regarding the elements of a transaction does not, by itself, give rise to any inference that an organization manager knowingly participated in the transaction.



Appropriate professionals, on whose written opinion an organization manager may rely, are limited to:

- legal counsel, including in-house counsel;
- certified public accountants or accounting firms with expertise regarding the relevant tax law matters; and
- independent valuation experts who:
  - hold themselves out to the public as appraisers or compensation consultants;
  - perform the relevant valuations on a regular basis;
  - are qualified to make valuations of the type of property or services involved; and
  - include in the written opinion a certificate that the above requirements are met.

A written opinion is reasoned even though it reaches a conclusion that is later determined to be incorrect so long as the opinion addresses itself to the facts and the applicable standards. However, a written opinion is not reasoned if it does nothing more than recite the facts of the transaction and express a conclusion.

(5) Safe Harbor – Reliance on the Rebuttable Presumption of Reasonableness

Under this safe harbor, an organization manager is ordinarily not considered to have “knowingly” participated in a transaction, even though the transaction is later held to be an excess transaction, if the appropriate authorized body has met the requirements of the rebuttable presumption of reasonableness with respect to the transaction.

(6) Liability of Organization Managers

Any organization manager who participated in the excess benefit transaction must pay the 10% tax. All managers liable for the 10% tax with respect to an excess benefit transaction are jointly and severally liable for it. If an organization manager also receives an excess benefit from an excess benefit transaction, the manager may be liable for both the 10% tax and the 25% tax. For any one excess benefit transaction, the maximum amount of tax imposed the organization managers may not exceed \$20,000.

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