TAX-EXEMPT ORGANIZATIONS ALERT

HOW TO AVOID EXCESS BENEFIT TRANSACTIONS WHEN COMPENSATING OTHERS

I. Overview

In recent years, the IRS has paid closer attention to whether tax-exempt organizations are paying too much in compensation to individuals and entities that might be in a position to unduly influence the organization.

The Internal Revenue Code authorizes the IRS to impose excise taxes known as intermediate sanctions on any "disqualified person" who partakes in an "excess benefit transaction."[1]

Tax-exempt organizations must be aware of the authority the IRS has to impose financial penalties on individuals and entities who receive excess compensation, as well as the directors and officers who authorize these payments.

This alert provides an overview of the intermediate sanctions rules and addresses several potential pitfalls that tax-exempt organizations should be aware of to prevent an excess benefit transaction. Potential issues include determining:

- which individuals and entities are subject to these rules,
- the scope of excess benefit transactions, and
- which transactions are considered automatic excess benefit transactions.

II. Safe Harbor Rule

The rules regarding excess benefit transactions can leave a tax-exempt organization confused about what it should do. How can an organization be sure that the IRS won't later say that a payment made to a disqualified person was an "excess benefit transaction"?

[1] Although the scope of the following terms is discussed more fully below, in general, a "disqualified person" is an individual or an entity that is in a position to exercise substantial influence over the exempt organization, and an "excess benefit transaction" is any transaction in which the value of the economic benefit provided by the tax-exempt organization to a disqualified person exceeds the fair market value of the consideration received by the organization in return. The "excess benefit" in such a transaction is equal to the difference between the value of the economic benefit provided and the value of the consideration received.

To deal with this uncertainty, Congress added a safe harbor to the Internal Revenue Code which provides that a tax-exempt organization can minimize the risk that the IRS will later determine that the organization has engaged in an excess benefit transaction. Under the safe harbor rule, payments made to a disqualified person are deemed reasonable if:

(1) The board of directors (or other authorized body) of the organization approves the payment in advance; [2]
(2) Prior to making its determination, the Board finds that the payment was reasonable, based on relevant outside comparability data; and
(3) When making its determination, the authorized body adequately documents the basis for its decision.

Where a tax-exempt organization has followed the safe harbor rule, the burden of proof shifts to the IRS to demonstrate that the payment was unreasonable.

III. Penalties for Excess Benefit Transactions

If an excess benefit transaction has occurred, the disqualified person must correct the excess benefit by repaying the excess benefit, plus interest, or by returning previously transferred property. The IRS may also impose on the disqualified person an excise tax equal to 25% of the excess benefit. If the disqualified person fails to correct the excess benefit within the required period of time, then the disqualified person is liable for an additional excise tax equal to 200% of the excess benefit.

The IRS may also impose an excise tax equal to 10% of the excess benefit on any organization manager who knowingly approved the excess benefit transaction, unless such participation was not willful and was due to reasonable cause.

IV. Disqualified Persons: They're Not Just Executives

Only payments made to a "disqualified person" are subject to the excess benefit rules. Therefore, it is important for a tax-exempt organization to understand who within the organization is a disqualified person so that the organization may avoid providing excess benefits to these persons.

Under the Internal Revenue Code, disqualified persons include not only organization executives, but potentially many other individuals and entities with ties to the organization.

For example, the plumber who provides services to the organization, and who is also the treasurer's brother-in-law, is a disqualified person. So, too, is the advertising company that rents office space from the organization, and that happens to be 50-percent-owned by a board member of the organization.

[2] None of the individuals involved in making the determination may have a conflict of interest with respect to the transaction.

Disqualified persons include three broad classes of persons:

(1) any person who is in a position to exercise substantial influence over the affairs of the tax-exempt organization, or who was in such a position during the preceding five years;
(2) the family members of such persons, including spouses, as well as ancestors, children, grandchildren, great grandchildren, brothers and sisters (whole or half), and their respective spouses; and
(3) any entity in which the above two classes of persons hold more than a 35% interest.

The IRS considers the following persons to have substantial influence:

- voting members of the board of directors;
- persons who are responsible for implementing the decisions of the board or for supervising the management of the organization (e.g., presidents, executive directors, chief executive officers, or chief operating officers); and
- persons who have ultimate responsibility for managing the finances of the organization (e.g., the treasurer, chief financial officer or director of finance).

On the other hand, the IRS has deemed the following persons not to have substantial influence:

- public charities that do business with the organization;
- Section 501(c)(4) advocacy organizations that work with the organization; and
- certain employees of the organization who:
  - receive less than $80,000 in annual compensation and benefits;
  - are not substantial contributors to the organization; and
  - who are not otherwise disqualified persons.

With respect to all other persons, the IRS applies a facts and circumstances test to determine whether they have substantial influence. The IRS tends to view individuals and entities who are integrally involved in the management or finances of the organization as having substantial influence.

For example, individuals:

- who control a substantial portion of the organization's budget,
- who are in charge of activities that produce a disproportionate amount of the organization's income, or
- whose compensation is primarily based on revenues derived from the organization's activities,

are more likely to be regarded as having substantial influence. So, too, are the organization's founders, substantial contributors, and persons owning a controlling interest in any corporation, partnership, or other entity that would qualify as a disqualified person.

The IRS is less likely to regard as having substantial influence persons:

- who do not participate in management decisions,
- who do not receive preferential treatment in exchange for contributions to the organization,
- whose direct supervisor is not a disqualified person,
- who have taken religious vows of poverty, or
- who are contractors whose sole relationship to the organization is providing professional advice (e.g., an attorney, accountant, or investment manager or advisor).

V. Excess Benefit Transactions: Not Just Compensation

An "excess benefit transaction" is any transaction in which the value of the payment made by the tax-exempt organization to a disqualified person exceeds the fair market value of the consideration received by the organization.

Payments can take the form of cash, transfers of property, providing services, or any other benefit that has economic value to the disqualified person.

The definition of an excess benefit transaction is broad, and encompasses many financial transactions other than executive compensation, including loans, rentals of property, and sales of property at less than fair market value.

For example, if the tax-exempt organization loans $10,000 at a below-market interest rate to a technology start-up that is 50% owned by the president's granddaughter, or if the organization sells office furniture to the spouse of that granddaughter for an amount that is less than fair market value, these are excess benefit transactions.

In determining whether an excess benefit transaction has occurred, all consideration and benefits exchanged between the tax-exempt organization and the disqualified person are taken into account.[3]

Tax-exempt organizations must also keep in mind that the economic benefit may be provided directly by the organization or indirectly through an entity controlled by the organization or an intermediary.

An entity is considered a "controlled entity" where the tax-exempt organization owns more than a 50% interest in the entity. An intermediary includes anyone who participates in a transaction with one or more disqualified persons.

[3] The only exceptions are:

- nontaxable fringe benefits,
- nontaxable expense reimbursement payments,
- benefits provided to the general public in exchange for a membership fee or contribution of $75 or less per year,
- benefits provided to a member of the organization solely on account of his or her payment of a membership fee,
- benefits provided to a donor solely on account of a charitable contribution,
- benefits provided to a charitable beneficiary, and
- benefits provided to the government for a public purpose.

The payments provided by the intermediary are attributed to the tax-exempt organization where the organization provides an economic benefit to the intermediary and there is an understanding that the intermediary will make payments to a disqualified person, or the intermediary makes payments to the disqualified person without a significant business purpose of its own.

For example, suppose an individual was last employed by ABC Charity, a tax-exempt organization, three years ago, and is a disqualified person with respect to the organization. Suppose also that this individual is hired for a research position by XYZ Institute, an organization that is unrelated to ABC Charity. Finally, suppose the research position was funded by a grant from ABC Charity to XYZ Institute. If there is an understanding between ABC Charity and XYZ Institute that XYZ would use the grant to provide a position to the individual, then ABC Charity provided an economic benefit to the disqualified person through the use of an intermediary.

VI. <u>Beware of Automatic Excess Benefit Transactions</u>

Generally, for the excess benefit rules to apply, the organization must transfer more to the disqualified person than the organization receives back in payment. For example, the rules apply if the tax-exempt organization sells property to a director for $80,000, even though the property is worth $125,000, resulting in an excess benefit of $45,000.

However, a transaction may qualify as an "excess benefit transaction" even if the value of the payments made to the disqualified person equals the value of the services provided by the individual. This type of transaction is called an "automatic excess benefit transaction."

When a tax-exempt organization makes a payment to a disqualified person in exchange for services, the organization must clearly indicate its intent to treat the benefit as compensation for tax purposes by providing contemporaneous written substantiation of its intent. [4]

Contemporaneous written substantiation occurs when:

- The organization reports the benefit as compensation on a Federal tax return, such as a Form W-2 or Form 1099 or on the organization's Form 990, or
- The disqualified person reports the payment as income on a Federal tax return, such as a Form 1040.

Other evidence may be used to demonstrate the organization's intent to treat the benefit as compensation, including:

- an approved written employment contract executed on or before

[4] This requirement does not apply to nontaxable economic benefits that are excluded from a disqualified person's gross income for income tax purposes (e.g., employer-provided health benefits and contributions to qualified pension, profit-sharing, or stock bonus plans).

the date of the transfer treating the benefit as compensation,

- documentation indicating that the authorized body approved the transfer as compensation for services before the transfer, or
- written evidence indicating a reasonable belief by the tax-exempt organization that the benefit was a nontaxable benefit, such as an opinion of counsel or tax accountant.

If the organization fails to comply with the substantiation requirement, the services provided by the disqualified person are disregarded for purposes of determining whether the transaction was reasonable. As a result, the value of the payment provided to the disqualified person is likely to outweigh the consideration received by the tax-exempt organization and the transaction will constitute an excess benefit transaction, regardless whether the overall amount of compensation is reasonable.

These rules can be illustrated by the following example. Suppose an organization hires a new executive director and agrees to pay a lump sum amount to offset some of the executive director's relocation expenses. The tax law provides that this payment should be taxable to the employee, but the organization fails to report it as taxable compensation on the executive director's W-2 or on the organization's Form 990. The employee does not report the payment as income on the employee's Form 1040. No other documentation exists to show that the payment was intended to be treated as taxable compensation. The payment is considered an automatic excess benefit transaction, even if it was reasonable for the organization to pay the new executive director's relocation expenses.

As a result, the executive director must return the payments to the organization and pay a 25% penalty tax to the IRS on the amount of the transaction.[5]

The harsh effect of this rule can be avoided if the problem is noticed in time and the executive director or the organization files an amended tax return reporting the payment as taxable compensation, and the employee pays tax on the payments.

VII. Recommendations Going Forward

Whenever a tax-exempt organization enters into a transaction with a disqualified person, it should follow these six important steps:

1. The board of directors must be careful to determine that the payment made by the organization to the disqualified person exceeds the value of the consideration it receives in return.

[5] If a tax-exempt organization's failure to report an economic benefit as compensation is reasonable, then the organization is treated as having clearly indicated its intent to provide the economic benefit as compensation for services. To show reasonable cause, the organization must establish that there were significant mitigating factors or that the failure arose from events beyond the organization's control, and that the organization acted in a responsible manner both before and after the failure occurred.

2. In ascertaining the value of the economic benefit, the organization must look to comparable arm's length arrangements involving similar services or property, in the same geographic location, and within the same industry.
3. The tax-exempt organization should consider obtaining professional help when reviewing any potential excess benefit transactions.
4. Where possible, the organization should attempt to qualify for the safe harbor.
5. The tax-exempt organization should carefully document the transaction, including keeping a record of any comparability data used when evaluating the transaction and keeping careful minutes of any meeting at which the matter was discussed.
6. The organization must also be careful to accurately report the transaction on its tax forms to avoid any automatic excess benefit transactions.

VIII. Additional Resources

You may find the following information helpful:

In Setting Executive Compensation, a Tax-Exempt Organization Should Consider Following the IRS'S Requirements to Establish a Rebuttable Presumption that the Compensation is Reasonable
http://www.fileden.com/files/2010/8/6/2935022/Alert%20--%20DC%20Bar%20Compensation%20Alert.pdf

IRS Website: Excise Tax on Excess Benefit transactions:
http://www.irs.gov/charities/charitable/article/0,,id=123298,00.html