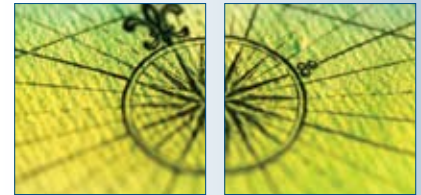


client advisory bulletin

Intermediate Sanctions

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Issue 13



Background In the 1990s, executives at several large not-for-profit organizations were found guilty of using the organizations' funds for personal gain. As a result of these various abuses, the House Subcommittee on Oversight started a process of hearings to determine what penalties, other than revocation of an organization's tax exempt status, could be imposed in cases of excess benefit transactions. With the passage of the Taxpayer Bill of Rights in 1996, Congress found a middle ground between no penalties imposed on tax-exempt organizations and the revocation of their tax-exempt status by establishing "Intermediate Sanctions." These "sanctions," found in IRC §4958, impose excise taxes on various parties involved in an excess benefit transaction. With the IRS continuing to crack down on excess compensation within not-for-profit organizations, now is the time to review your compensation policy to ensure your organization is in compliance.

Organizations Affected IRC §4958 applies to tax-exempt organizations that currently fall under IRC §501(c)(3) and §501(c)(4) as well as any organization that was exempt under these classifications if the excess benefit transaction occurred in the past five years. This means that tax-exempt public charities and social welfare organizations, including the organizations that they control, fall under §4958. Public charities typically include: churches; colleges, universities, or schools; hospitals or other healthcare providers; units of government; and publicly supported charitable, educational, religious, or scientific organizations. Social welfare organizations are those that are civic in nature, assist the community in various ways, or are engaged in some form of advocacy, typically lobbying.

Key Terms The IRS can impose excise taxes on "disqualified persons" and "organization managers" if they are party to an "excess benefit transaction" from their tax-exempt organization.

- A "disqualified person" is any person who is in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization. This definition would include, for example, voting members of the governing body and persons holding the power of President, Chief Executive Officer, Chief Operating Officer, Treasurer, and Chief Financial Officer.
- An "organization manager" is any officer, director, or trustee of an applicable tax-exempt organization, or any individual having similar responsibilities, regardless of title.
- An "excess benefit transaction" is a transaction in which the value of the economic benefit received by the disqualified person is greater than the value of services that he or she provides to the organization. Fair market value is used to determine the excessiveness of the transaction.

Tax Implications/ Penalties In the event that an excess benefit transaction takes place between the applicable tax-exempt organization and a disqualified person, an excise tax equal to 25% of the excess benefit is imposed on the disqualified person. The disqualified person who benefited from the excess benefit transaction is liable for the tax and is also required to pay back the excess amount with interest. If an imposed excise tax is not paid within the correction period allowed by the IRS, an additional excise tax equal to 200% of the excess benefit is imposed on the disqualified person.

About Findley Davies

Findley Davies works with companies interested in maximizing the effectiveness of their human resources strategies. They specialize in helping clients attract and retain talent, enhance the effectiveness of HR processes, leverage technology, improve financial performance through effective management of costs, and structure solutions that drive organizational change.

Established in 1969, Findley Davies is owned by a group of senior consultants working from offices in Charlotte, Cleveland, Columbus, Greensboro and Toledo. Its consultants, actuaries, and administrators are accomplished professionals with proven track records in HR, ERISA and tax law, retirement plans, actuarial science, compensation and rewards, communications, health and group insurance, and HR Innovation.

Comments and Questions

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Furthermore, IRC §4958 also imposes excise taxes on organization managers who knowingly and willfully participate in the excess benefit transaction. In this situation, the participating organization manager will have a 10% excise tax (not to exceed \$20,000) levied on him or her. Each organization manager who participates will be individually responsible for paying the tax imposed.

Avoiding Excise Taxes

While the law imposes penalties on excess benefit transactions, it also provides a process by which an organization can create a rebuttable presumption that compensation paid is reasonable. By creating a rebuttable presumption, the burden of proving the existence of unreasonable compensation shifts from the organization to the IRS. This shift can be made if the following three conditions are met:

1. The compensation transaction is approved by an authorized body of the organization, which is composed of individuals who do not have a conflict of interest concerning the transaction.
2. The authorized body, prior to making its determination, relied upon independent comparative data.
3. The authorized body adequately and concurrently documents the basis for making the compensation decision.

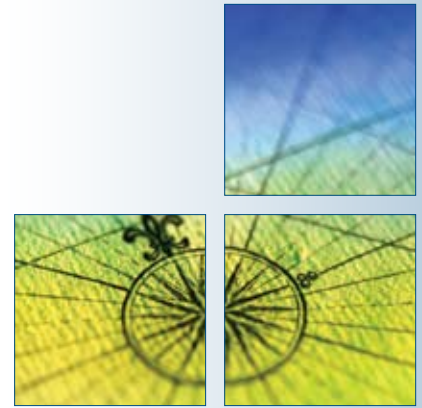
In summary, the IRS guidelines provide an opportunity for the creation of a rebuttable presumption that compensation is reasonable. This is done through an objective decision-making process, use of comparative data, and the appropriate documentation of the relevant decisions related to compensation of disqualified persons.

What Should You Do?

Findley Davies recommends the following actions be taken in light of the IRS's continuing trend to crack down on excess compensation within not-for-profit organizations:

- Perform an annual market analysis to ensure appropriate pay for all disqualified persons.
 - Follow the IRS three step protocol to establish a Rebuttable Presumption.
- Ensure full disclosure and accuracy with the new Form 990; including new changes:
 - All current officers, directors, and trustees must be listed, regardless of compensation; including top management and financial officials;
 - Reported compensation should be from the individual's W-2 or Form 1099; and
 - Schedule J (Compensation Information) is now more comprehensive with regard to reporting benefits and perquisites and overall compensation.
- Seek guidance when in doubt!

Findley Davies can provide guidance and support by performing annual market analysis for all disqualified persons, advising on Form 990 requirements, and helping meet the requirements necessary to establish a rebuttable presumption for IRC §4958 purposes.



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