Tax Exempt Organization Intermediate Sanctions Worse Than the Death Sentence? Or Why Less is More

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Practice Area: Nonprofit and Tax Exemption

On July 30, 1996, President Clinton signed into law the Taxpayer Bill of Rights II. The Bill includes the long awaited "intermediate sanctions" provisions which provide the IRS with a new enforcement tool in policing exempt organization compliance with the private inurement prohibition. New Internal Revenue Code section 4958 imposes an excise tax on disqualified persons and exempt organization managers who participate in "excess benefit transactions occurring after September 14, 1995." The tax does not apply to the organization. The Bill also expands the private inurement prohibition to apply to section 501(c)(4) organizations, in addition to section 501(c)(3) organizations.

Under prior law the IRS' only enforcement tool was to revoke tax exempt status – the equivalent of imposing a "death sentence" on the exempt organization. The IRS has always been reluctant to use the death sentence because of its draconian impact on legitimate charitable activities and the constituents they serve. As a result, the death sentence was only used in the most severe cases.

Now the IRS can impose excise tax penalties on the individuals involved in transactions that provide excess benefits, without affecting exempt status. Although the excise tax is much less severe than the death penalty, section 4958 will likely result in more enforcement activity. Exempt organization executives need to understand the basics of the intermediate sanction provisions and what steps they should take to avoid facing an enforcement action.

Intermediate Sanction Basics

Excess Benefit Transactions. Any transaction in which an exempt organization directly or indirectly provides an economic benefit to or for the use of any disqualified person, where the value of the economic benefit exceeds the consideration provided to the exempt organization for such benefit.

Disqualified Person. Any person who, at any time during the five-year period ending on the date of a transaction, was in a position to exercise substantial influence over the affairs of the organization, or was a family member of such an individual. A disqualified person may also include another entity, such as a corporation or partnership, of which more than 35% of the total voting power is controlled by individuals who are disqualified persons.

First Tier Penalties. An excise tax on the disqualified person receiving the excess benefit, equal to 25% of the excess benefit; and an excise tax equal to 10% of the excess benefit, limited to $10,000, on any organization managers who participated in the transaction, unless such participation was not willful and was due to reasonable cause.

Second Tier Tax. The law imposes a second level of tax on any excess benefit transaction upon which a first tier tax is imposed, and which is not corrected within a specified assessment period after notice of the first tier tax.

Correction. The law defines correction of an excess benefit transaction as undoing the transaction to the extent possible and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the fiduciary standards.

Operational Implications

The new law requires the IRS to issue regulations providing further guidance on certain aspects of the intermediate sanction law. These regulations will likely incorporate the comments provided in the committee report. The report states the Congressional intent that there be a rebuttable presumption in favor of the reasonableness of a transaction, if the organization has gone through a series of steps up front to demonstrate the reasonableness of the transaction. The report indicates that this presumption will apply where the transaction has been reviewed by the Board of Directors, or a designated committee, that is independent from any disqualified person involved. Organizations that follow such a process will benefit from a presumption in favor of reasonableness, that must be overcome by the IRS.

The intermediate sanction law will also make documentation of the fair market value of the terms of a transaction even more important than it has been under prior law. The use of independent appraisals, or the gathering of data on comparable transactions, will become a key factor in demonstrating the reasonableness of the transaction and that no excess benefit exists.

Exempt organization executives will also need to consider adding terms requiring repayment of any amounts found to be an excess benefit to contracts with persons who may be disqualified persons. Such a recoupment term would provide a contractual right to "correct" the transaction and will in fact be in the best interest of the other party. The second tier 200% tax applies only to the disqualified person. There is no second tier tax on organization managers.

Finally, exempt organizations should address whether any excess benefit excise tax imposed on its managers will be reimbursed by the organization under its employee indemnification policy. Section 4958 states that the 10% excise tax shall be paid by the organization manager, but otherwise contains no explicit prohibition of indemnification by the employer. Indemnification will be governed by state corporate law and the specific provisions of the organization's bylaws and corporate policies.

Most state non-profit corporate law contains limitations on the personal liability of directors and officers and establishes rules governing indemnification by the corporation. The application of these laws and existing corporate policy to the new excise tax should be reviewed. It will be important to balance the application of state law against the potential that indemnification could itself raise excess benefit issues under Federal law.

Conclusions

In the past, the draconian implications of the death sentence have, in effect, protected exempt organizations from more aggressive enforcement of the private inurement prohibition. The IRS can now penalize the bad actors rather than the entire organization and the charitable class it serves. As a result, we should see much more IRS activity in this area.

The new law makes it very important for exempt organizations to be proactive in addressing these issues. The best course is to establish procedures and compliance programs that will trigger the presumption in favor of reasonableness, and to thoroughly document the financial reasonableness of transactions.

This will be an area to watch for further developments as the IRS releases guidelines and regulations. We will keep you informed as developments unfold.
