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Beware of Penalties in Transactions With Not-for-Profits

Tax law provisions and IRS regulations may have a significant impact on improper transactions between top officials and a tax-exempt organization.

Under old rules from years ago: When the IRS determined that a top official engaged in a transaction and received an unfair benefit given his or her position in the organization, the only recourse was to revoke the tax-exempt status. This penalty was so severe that it was rarely imposed by the IRS because it would hurt innocent parties.

Under newer rules: The IRS now has an intermediate checks and balances measure to impose financial penalties on parties involved in an excess benefit transaction. With this more reasonable option, the IRS is more likely to penalize individuals.

The relevant provisions, which apply to all transactions with non-profit organizations after September 14, 1994, are commonly referred to as the "Intermediate Sanctions." These sanctions are designed to protect charities and donors from those insiders who wield the influence to permit excessive executive compensation. Intermediate steps allow the IRS to target guilty parties for punishment, rather than inadvertently punishing innocent parties by revoking the charity's tax-exempt status. The IRS later issued regulations to assist in interpreting the law.

Key point: Applying the Intermediate Sanctions penalty doesn't preclude the loss of tax-exemption. Rather, it may be imposed by the IRS *in addition* to the loss of the tax-exempt status.

Who is Liable?

Individuals who are in a position to exercise substantial influence over the affairs of a tax-exempt organization at any time during the five-year period preceding the date of the questionable transaction. The IRS calls these individuals "disqualified persons."

The regulations state that "substantial influence" is likely present if an individual:

- Is a voting member of the organization's governing body (such as the Board of Directors or Board of Trustees).
- Is an executive officer of the organization such as CEO, COO or president.
- Manages the organization's finances (such as the Treasurer or CFO).
- Has a material financial interest in a Medicare+Choice provider-sponsored organization, which is owned (at least in part) by an exempt organization.
- Has compensation that is primarily based on revenues from activities that the person controls.
- Manages a segment or activity of the organization that represents a substantial part of the activities, assets, income or expenses.

Arrangements that are subject to the Intermediate Sanctions Rules are known as excess benefit transactions. The Internal Revenue Code defines an excess benefit transaction as one in which the economic benefit provided, directly or indirectly, by a tax-exempt organization to an individual exceeds the fair market value for the consideration received by the tax-exempt organization.

When Determining if a Transaction is an Excess Benefit, the IRS Considers:

1. **The compensation received** by the disqualified individual.

2. **Any other benefit received** (except the value of certain non-taxable fringe benefits and benefits provided to volunteers or charitable beneficiaries). This may include items such as salary, bonus, luxury travel or paid travel of a spouse, property given to the individual and certain insurances paid by a tax-exempt organization.

3. **Embezzled amounts.** Ironic as it may seem, the regulations suggest that -- notwithstanding the other legal implications -- embezzled amounts by a disqualified individual are also to be considered as an economic benefit and are subject to this law.

In determining fair market value, the total compensation for the services provided is compared with the amount that would ordinarily be paid for similar services by a similar organization. Unfortunately, what constitutes "reasonable compensation" is often uncertain because every transaction must be evaluated separately given the applicable facts and circumstances.

Note: The regulations don't provide guidance regarding revenue sharing transactions. For top officials and tax-exempt organizations alike, this has been a subject of great confusion in recent years. Both the IRS and the Office of Inspector General have issued conflicting opinions regarding the legitimacy of revenue sharing or gain sharing transactions.

As with many tax laws and regulations, the regulations are extremely complex.
If you're uncertain whether this law applies to you, contact your tax adviser. It's important to correct any possible excess benefit transactions *before* an IRS audit. If you do that, you should be able to avoid any financial penalties under the Intermediate Sanctions rules.

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