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Penalty Taxes on Managers and "Insiders" of Organizations Exempt from Tax under Section 501(c)(3) or (c)(4)

"Intermediate Sanctions" for "Excess Benefits"

Until 1996 the only weapon that the Internal Revenue Service had to attack overly compensated executives of public charities was revoking the tax-exempt status of the organization. It was reluctant to do this, because the people served by the organization would be hurt by this, possibly as much or more than the targeted executive. In 1996 Congress gave the IRS new weapons, known as "intermediate sanctions" because they are less drastic than revoking the organization's tax-exempt status.[1]

[1] Private foundations have been subject to a similar penalty tax regime since 1969.

Managers of organizations exempt from tax under Section 501(c)(3) or (4) are subject to special penalty taxes (called "excess benefit taxes") if the organization provides benefits (such as compensation) to managers or other insiders and the value of those benefits exceeds the value of the products or services that the organization receives in return.[2] The penalty taxes are imposed on both the persons

[2] I.R.C. § 4958. Particularly suspect are arrangements in which insiders receive compensation based on a percentage of the organization's revenue. Such arrangements will be treated as excess benefits unless the organization and its managers can prove otherwise.

who receive the "excess benefit" and the managers who approve it -- and not on the organization. An "insider" is any person who within the five-year period preceding the transaction was in a position to "exercise substantial influence" over the organization, and probably includes major donors as well as directors and officers.

For the benefited insider the tax is initially 25% of the excess benefit, but increases to 200% of the excess benefit if the insider does not promptly unwind the transaction in a way the IRS accepts. For managers who do not receive the excess benefit but knowingly and willfully approve it, the tax is 10% of the excess benefit, up to a maximum of $10,000 per transaction. The tax on managers applies to them as a group, and the IRS can collect all of it from any of them.

A "safe harbor" is available if the compensation was approved by a committee of the board (typically called a "compensation committee") and certain requirements are met:

- The committee must be composed entirely of individuals unrelated to and not subject to the control of the insider(s) involved in the transaction;
- The committee must obtain, review and rely upon appropriate data as to comparability: (i) compensation levels paid by similarly situated institutions, both taxable and tax-exempt, for functionally comparable positions; (ii) the availability of similar specialties in the geographic area; and/or (iii) independent compensation surveys by nationally recognized independent firms, or actual written offers from similar institutions competing for the services of the disqualified person.
- The committee must adequately document the basis for its determination. For example, include in the minutes an evaluation of the individual whose compensation is being established and the basis for determining that his or her compensation is reasonable in light of that evaluation and data.
- Include in Form W-2 compensation all fringe benefits that the organization provides to its executives, so that the presumption of reasonableness can apply to

them. Fringe benefits not included in compensation will not be treated as provided to the executive in exchange for his or her services, and so risk characterization as "excess benefits."

Although it has not been officially listed as a factor that helps to establish the presumption of reasonableness, it probably will help if the organization adopts and adheres to a policy to identify conflicts of interests between the organization and its managers, other insiders and their relatives and affiliates. The IRS currently instructs its agents to consider this in its investigations of insider transactions.[3] Such a policy would periodically require each officer and director to indicate in writing whether he/she or his her family members or business affiliates were doing business with the organization.

[3] FY 1997 CPE, "Tax-Exempt Health Care Organizations Community Board and Conflicts of Interest Policy." p. 17, 21.

O*rganizations should make every effort to comply with the compensation safe harbor.*

The organization may indemnify a manager (who is not the benefited insider) for the penalty tax, but the amount of indemnification is included in his or her compensation.[4] If an organization purchases liability insurance to cover managers and insiders against potential excise tax liability, the premiums for that coverage must be treated as compensation to them. Officers should determine whether their organization's existing D&O insurance, if any, affords coverage for this potential tax liability. We can assist with this review.

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[4] The organization can indemnify the insider, but the amount of the indemnification will be included in his or her compensation -- which in many cases will exacerbate the excess benefit problem.