

Intermediate Sanctions

Guarding against misuse of charitable assets by officers, directors, and other "insiders" has long been regarded as fundamental to maintaining public confidence in the charitable sector. Accordingly, section 501(c)(3) prohibits payment of excessive compensation, "sweetheart" contracts, and other "private inurement" of charitable assets for the benefit of those in control of the organization. However, until 1996, the only sanction available to the IRS to enforce this ban on private inurement was revocation of the charity's tax exemption; the IRS had no authority to penalize the insider who had misused his or her position for private gain.

To remedy this serious weakness in federal law, Congress – with broad support from the charitable sector – in 1996 enacted the intermediate sanctions rules (so called because they provide for targeted sanctions short of revoking a charity's exemption). These rules are codified in section 4958 of the Internal Revenue Code.

Disqualified Persons

A disqualified person is one who, at any time during the five years prior to the transaction in question, was "in a position to exercise substantial influence over the affairs of the organization." A disqualified person's family members, and any entity in which a disqualified person or family member owns more than a 35% interest, also are disqualified persons.

Automatic disqualified persons – voting members of an organization's board, the president, the chief executive and chief operating officers, the treasurer, and the chief financial officer.

Automatic not disqualified persons – All individuals deriving an annual economic benefit from the organization of less than the amount sufficient to cause someone to be a "highly compensated employee" – for 1998, approximately \$80,000.

Other persons – For everyone else connected with a covered organization, the determination of disqualified person status is made under a "facts and circumstances" test. The following circumstances tend to show that a person has substantial influence over an organization:

1. Founder of the organization
2. Substantial contributor to the organization
3. Receives compensation based on revenues of activities that person controls
4. Authority to control a "significant portion" of capital expenditures, operating budget, or compensation of employees of the organization
5. Managerial authority or is "key advisor" to a person with managerial authority
6. Owns a controlling interest in an entity that is a disqualified person.

The following circumstances tend to show that a person is not a disqualified person:

1. Taken vow of poverty as an employee/agent of religious organization
2. Independent contractor
3. If a contributor, receives only such preferential treatment as is available to any other donor

Excess Benefit Transactions Based on Fair Market Value

Statute defines an excess benefit transaction as "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit."

Transaction Not an Excess Benefit Transaction

Transaction will be presumed to be fair market value if the organization implements as many of the following procedures as possible.

1. Arrangement must be approved by members of organization's board or board-appointed committee, none of whom have a conflict of interest.
2. Board/committee must have obtained and relied upon "appropriate data" as to comparability/fair market value of the consideration.

3. Board/committee must document basis for determination.

Revenue-Sharing Transactions

A revenue-sharing transaction may constitute an excess benefit transaction – and be subject to intermediate sanctions – if “at any point, it permits a disqualified person to receive additional compensation without providing proportional benefits that contribute to the organization’s accomplishment of its exempt purpose.”

Application of Excise Taxes

There are two first-tier taxes and one second-tier tax, the latter of which can be imposed only if the excess benefit transaction is not corrected.

1st Tier: 25% tax on disqualified person and 10% tax (capped at \$10,000 for a single transaction) on any organization manager who “knowingly” participated in excess benefit transaction.

2nd Tier: disqualified person is subject to an additional tax of 200% of the excess benefit.

Applicable Tax-Exempt Organizations

1. 501(c)(3) or 501(c)(4) (excluding private foundations)
2. Public universities not filing for 501(c)(3) exemption
3. Foreign organizations receiving substantially all support from sources outside US

Operational Recommendations

Steps to minimize exposure to intermediate sanctions

1. Identify disqualified persons.
2. Consult with counsel to develop procedures for ensuring transactions with disqualified persons receive appropriate review.
3. Review and regularize record-keeping practices. (especially make record of board consideration and deliberate decision concerning a transaction)
4. Identify and review appropriate comparability data for compensation arrangements with disqualified persons. Again, document the review.
5. Any transactions with a revenue-sharing component should be reviewed carefully for proportional benefit to the organization.