Intermediate Sanctions provisions do not automatically or necessarily prevent the IRS from revoking the organization's tax-exempt status.

What are Intermediate Sanctions?

Prior to the penalty of Intermediate Sanctions, revoking the tax-exempt status of an organization was the only way the IRS could enforce the various rules and requirements applicable to organizations exempt from federal income tax. In many instances, the IRS found that the revocation of exemption was a harsh penalty for relatively small indiscretions of nonprofit organizations. As a result, the IRS developed an alternative, "intermediate" penalty – Intermediate Sanctions.

Intermediate Sanctions are provisions used to penalize individuals who benefit from their executive role within a tax-exempt organization. The provisions allow the IRS to hold disqualified persons accountable for receiving excessive economic benefits from the organization without penalizing the entire organization with revocation of tax-exempt status. However, Congress and the IRS have continued to remind organizations that the Intermediate Sanctions provisions do not automatically or necessarily prevent the IRS from revoking the organization's tax-exempt status.

Who is Affected by Intermediate Sanctions?

Intermediate Sanctions affect an organization's "disqualified persons" and managers. "Disqualified persons" are defined as any person who was or is in a position to implement substantial authority over the decision-making process within an organization. The time frame for the disqualified person's authority can be any time during a five-year period ending on the date of the transaction. Disqualified persons can include officers, directors, and executive employees of tax-exempt organizations, or a family member of a disqualified person. An organization's manager is defined as "any officer, director, or trustee of an organization who has similar powers" as a disqualified person.

What are the Penalties?

The penalties can be substantial for a disqualified person that benefits from an excess benefit transaction with an applicable tax-exempt organization. The individual is legally responsible for a tax of 25% of the excess benefit as stated in Section 4958 of IRC. The excess benefit is characterized as the compensation provided to the disqualified person that exceeds the economic value offered by the individual to the organization in return. Once the 25% tax is assessed, the disqualified person has a specified amount of time to correct the excess benefit. If the individual fails to correct the excess benefit within the allotted time frame, a second tax of 200% of the excess benefit is placed on the disqualified person.

Consider this Example

A nonprofit organization pays its Executive Director, John, $150,000 in total compensation. The compensation package is approved by three of the nonprofit's directors, even though they know that similar nonprofits in the area pay $120,000 or less for similar work.

The IRS receives a complaint from a former employee of the nonprofit stating that it is paying excessive compensation to John. The IRS audits the nonprofit and determines that reasonable compensation for John is only $110,000.

Thus, John received an "excess benefit" of $40,000. Here's what happens:

- John must pay the IRS a penalty tax equal to 25% of the excess benefit—in this case, $10,000;
- John must pay the $40,000 excess benefit back to the nonprofit; if he doesn't, he will have to pay an additional tax to the IRS equal to 200% of the excess benefit ($80,000);
- The three directors, who knowingly approved John's compensation, must jointly pay an excise tax equal to 10% of the amount of the excess benefit, up to a maximum of $20,000—in this case, $4,000.

Thus, at a minimum, the IRS will receive $14,000 in penalty taxes – $10,000 from John out of his own pocket and $4,000 from the three directors. The IRS would receive an additional $80,000 if John failed to pay the $40,000 back to the nonprofit.

Penalty Tax = $10,000

+Payback =$40,000

OR Penalty Payback = **$80,000**

Penalty Tax = $4,000

TOTAL PENALTY/PAYBACK

Total Penalty Tax = $14,000

+possible Payback = **$80,000**

3-Step Process to Ensure Compliance

Boards often have no clear-cut guidelines of what is deemed reasonable compensation for executives.

Intermediate Sanctions can create a challenge for tax-exempt organizations. The boards for such organizations must identify compensation levels that the IRS will deem to be reasonable for executives; however, boards often have no clear-cut guidelines of what is reasonable. The IRS, understanding of the challenge faced by tax-exempt organizations, has established a "rebuttable presumption of reasonableness" to help organizations determine reasonable executive compensation. Following the steps developed by the IRS helps to ensure that the compensation allotted to executives within the organization is reasonable. Once the compensation meets the requirements under the "rebuttable presumption of reasonableness" the burden of proof is on the IRS. If an organization fails to comply with the requirements of the "rebuttable presumption of reasonableness," the burden of proof is on the individual subject to the penalty.

When evaluating the reasonableness of compensation within a tax-exempt organization, the IRS conducts an in-depth analysis of the structure of the salary or compensation plan in order to determine the overall goal of the compensation plan. The purpose of the analysis is to determine if the goal was developed to serve the interest of private individuals, or to serve the interest of the organization. The IRS will conclude whether the compensation reflects a fair, competitive market value. In order to assist organizations in developing reasonable compensation, the IRS has identified three steps that can help organizations ensure that their executive compensation is reasonable.

Step 1

Identify an authoritative decision-making governing body (e.g., board of directors or trustees) whose members do not have any personal interest in the compensation arrangements or any other conflict of interest. This governing body must approve the compensation plan or salary structure.

Step 2

Gather and analyze compensation comparability data based on current labor market data. It is essential that the labor market data used is appropriate for the organization. The most effective way to utilize labor market data is through published compensation surveys.

To ensure that the labor market data is appropriate for the organization, the governing body should consider utilizing data with the following criteria:

- The data includes pay levels for comparable positions in similar organizations; and
- The data indicates compensation based on multiple factors, including industry, geographic region, and organization size in terms of both budget and employees.

Step 3

Once an executive compensation structure is determined, the governing body must document the reasoning behind the compensation structure. The documentation should include:

- The terms of the approved transactions and the date approved;
- The members of the decision-making body who were present during the transaction discussion and those who voted on it;
- The comparability data that was relied on by the decision-making body and how the data was obtained; and
- Any actions by a member of the decision-making body having a conflict of interest.

Attendance during the discussion of the approved compensation, a record of the final vote, and comparable data used in the decision should also be included in the documentation.

The Bottom Line

As the focus on executive compensation continues to increase, it is essential that organizations cautiously investigate and assess all compensation proposals and preparations. Organizations that are proactive regarding Intermediate Sanctions reduce the risk of penalties and or the revocation of tax-exempt status.

About Keating Advisors

Keating Advisors is a strategic human resource consulting firm that helps organizations develop their talent management strategy and reward solutions. We provide comprehensive services to our clients nationwide, including compensation strategy and design, labor market benchmarking, organizational design and employee surveys.

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