How to Read the *New* IRS Form 990

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Expansion: Section 4958 (the "Intermediate Sanctions" Rule)

Since the mid-1990s, an Internal Revenue Service rule addressing the problem of improper payments to certain individuals has been in effect. This rule is sometimes referred to as the "intermediate sanctions" rule. Before this rule about the only sanction the IRS had when a section 501(c)(3) improperly transferred assets to a private interest was to revoke its exemption. In many cases this was believed to be too extreme. The new rule provides a sanction between doing nothing and revoking an organization's tax-exemption.

This rule, prescribed under section 4958 of the Code, imposes a tax on "disqualified persons" on the "excess benefit" they have received from an "excess benefit transaction." A tax is also imposed upon board members who approved the transaction knowing it was an excess benefit transaction. An excess benefit transaction is one in which a disqualified person receives more from a section 501(c)(3) organization than she provides to the organization.

Thus, if a 501(c)(3) nonprofit organization provides its executive director with a compensation package that is far higher than that received by other persons in comparable organizations in the same geographical area who are performing services comparable to those performed by the executive director, it may be found that the executive director has been paid an unreasonable or excessive compensation and a tax may be imposed on the executive director under section 4958 of the Code. Generally the tax will be on the amount of the compensation package that was excessive. In some cases a tax will also be imposed upon members of the board of the nonprofit who approved the compensation package. An excessive compensation payment is called an "excess benefit transaction" under 4958.

As will be explained below, a payment of excessive compensation is just one kind of excess benefit transaction. For anyone reviewing a filer's Form 990 to determine what it reveals about the filer's performance, it will be of obvious interest to learn that the filer has engaged in an excess benefit transaction. Line 25a in Part IV on page 4 asks whether the filer engaged in any excess benefit transaction during the year and Line 25b asks whether it became aware of any excess benefit transaction for a prior year. If the filer answers either of these questions "Yes," it must complete Schedule L. (Schedule L is discussed in Chapter 8.)

Here is a hypothetical example. Suppose a 501(c)(3) organization pays its executive director $500,000 when the compensation for persons in comparable positions in the same geographical area is $300,000. The executive director would be a disqualified person, and if the IRS determined than an excess benefit transaction had occurred, a tax of 25% on the excess benefit (viz., $50,000) would be imposed on the executive director. If the executive director did not return the $200,000 to her organization on the earliest of the date she was notified of the tax or the date when the 25% tax was assessed, she would be subject to a second-tier tax of 200% (viz., $400,000). Each board member who approved the compensation knowing it was an excess benefit transaction would be subject to a tax of 10% ($20,000). There would be no second-tier tax on board members.

A "disqualified person" is defined as any person who is in a position to exercise substantial influence over the affairs of the organization. The Treasury Regulations under section 4958 define disqualified persons as including (1) board members, (2) presidents, chief executive officers or chief operating officers, (3) treasurers and chief financial officers, and (4) those others who facts and circumstances tend to show have substantial influence over the affairs of the organization.

What constitutes excessive or unreasonable compensation? For this question the Treasury Regulations under section 4958 are helpful. Here is what they say about reasonable compensation:

> The value of services is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation). Treas. Regs. §53.4958-4(b)(1)(ii).

Thus, generally speaking, to determine whether someone's compensation is reasonable, a comparison should be made of the compensation being paid to persons doing similar jobs in similar enterprises in the same geographical area.

If compensation is listed at Part VII of the Form 990 on page 7 which appears to a reader to be so high as to raise some question as to whether it might be excessive, it is likely that the filer may have developed some documentation supporting the compensation's reasonableness in order to comply with safe-harbor provisions (mentioned immediately below) of the 4958 regulations. A reader could request to see this documentation. It may be that the organization would comply with her request. It would not be legally required to. But such failure to comply in itself may be significant to the reader. Under the section 4958 Treasury Regulations, compensation arrangements between an organization and a disqualified person are presumed to be reasonable if the following conditions are satisfied. First, the board or a committee of the board has approved in advance the compensation without the disqualified person taking part in the vote. Second, the governing body awarding the compensation relied upon data as to comparable salaries. And third, the board adequately and contemporaneously with its decision documented the basis for its compensation award. Thus, as suggested, documentation supporting the compensation's reasonableness may be available.

A reader of the Form 990 may be interested in compensation information generally not to determine whether a filer has paid anyone excessively. For example, a nonprofit may be canvassing a number of similar organizations to learn what they are paying their respective executive directors. This has become an easy task now that organizations' Forms 990 are available on the internet. Furthermore, if any one or more of these organizations had prepared the documentation just described and were willing to share it with others, it would be very helpful for this inquiry.

The payment of excessive compensation is not the only type of excess benefit transaction. Any payment by a 501(c)(3) nonprofit to a disqualified person in which the nonprofit organization gets back from the disqualified person less in value than it paid the disqualified person would be an excess business transaction. Thus, many self-dealing transactions between board members and the nonprofits on whose board they sit may be excess benefit transactions. For example, if a board member sells a building to his nonprofit for $700,000 whose fair market value at the time of sale was only $400,000, this would be an excess benefit transaction and presumably a tax would be imposed on the $300,000 excess benefit. Self-dealing transactions are discussed at Chapter 8.