An Unfair Fight: IRS Enforcement of Intermediate Sanctions and Lessons Learned from Recent Tax Controversies

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Agenda

- Explain the consequences of excessive executive compensation
- Discuss rebuttable presumption of reasonableness
- Discuss recent IRS enforcement efforts

Tax Consequences of Excessive Compensation

Limits on Executive Compensation

- Exemption issues
  - Private inurement
  - Impermissible private benefit

- Intermediate Sanctions

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Exemption Issues

- Private Inurement
  - Code generally provides that no part of organization’s net earnings can inure to the benefit of any private individual or shareholder
  - Applies to organizations exempt under multiple sections of the Code, including but not limited to: 501(c)(3), 501(c)(4), 501(c)(6), and 501(c)(7)
- Impermissible Private Benefit

Exemption Issues

- Impermissible Private Benefit
  - Generally, tax-exempt organizations are required to limit their activities to those that further their stated mission
  - A non-exempt purpose is generally a purpose that serves a private rather than a public benefit, as such is generally called a “private benefit”
  - Provision of an impermissible private benefit is grounds for revocation
  - The private benefit prohibition is imposed on a more limited group of exempt organizations than private inurement, and may not be applicable to organizations exempt under 501(c)(6) or 501(c)(7)

Intermediate Sanctions

- International Revenue Code ("Code") section 4958 allows the Internal Revenue Service ("Service") to impose penalties on "disqualified persons" who participate in or approve "excess benefit transactions"
- These penalties are commonly referred to as the intermediate sanctions
- Similar to "private inurement" concept

Intermediate Sanctions

- Treas. Reg. Section 53.4958-3(c) lists specific persons who are in a position to exercise substantial influence, including:
  - Voting Members of the organization's governing body;
  - President, CEO, COO;
  - Treasurer and CFO;
  - Organization founders; and
  - Some donors

Intermediate Sanctions - Penalties

- Penalty for receipt of an excessive benefit:
  - Return the value of the excessive benefits to the organization; and
  - An excise tax of either:
    - 25% of the value of the excessive benefit if the benefit is returned to the organization prior to the issuance of a notice of deficiency by the Service, or
    - 200% of the value of the excessive benefit if the benefit is returned after the Service issues the notice of deficiency

Intermediate Sanctions - Penalties

- Penalty on organization managers for approval of an excessive benefit transaction:
  - Section 4958(a)(2) imposes a 10% tax on any organization manager that knowingly approves an excess benefit transaction
  - Liability under section 4958(a)(2) is joint and several and capped at $20,000 per transaction

Rebuttable Presumption of Reasonableness

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Rebuttable Presumption of Reasonableness

- Under section 53.4958-6 of the regulations, if the organization takes certain precautions in approving a transaction, there is a "rebuttable presumption" that the transaction is at fair market value

- To establish the rebuttable presumption:

  1. The transaction must be approved in advance by disinterested members of the organization's governing body;
  2. The governing body must obtain and rely on valid comparability data in approving the transaction; and
  3. The governing body must contemporaneously document its decision and the reason for its decision

Rebuttable Presumption of Reasonableness

Benefits of establishing the “rebuttable presumption”:

1. We have never seen the IRS attempt to rebut the presumption;
2. Provides board members with near absolute protection from excise tax on participation;
3. The very nature of the process, independent members using objective data, significantly mitigates the risk of over compensation;
4. Provides organization with a clear and easy explanation about compensation decisions; and
5. Allows the organization to affirmatively answer all Form 990 questions relating to the policies and procedures that the IRS deems to be most desirable.

Exemption Issues

- Section 53.4958-6(e) of the regulations provides that an organization's failure to establish the rebuttable presumption does not create any inference that a transaction is an excess benefit transaction. However, our experience representing organizations represents that this is not clearly the case Generally, tax-exempt organizations are required to limit their activities to those that further their stated mission

- The effect of failing to establish the rebuttable presumption:
  - In recent litigation and examinations, the IRS based its entire position on the fact that an organization failed to establish the rebuttable presumption of reasonableness
  - The IRS will prepare its own valuation, often using non-comparable organizations

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Lessons Learned:

The Unfair Fight

Lessons Learned—IRS Enforcement

- IRS
  - In speeches IRS officials have identified executive compensation as “far and away the most common risk area for nonprofits” and an issue that the IRS will “look at on every audit we do”
  - Executive compensation was discussed as a significant issue in the Interim Report for the IRS College and University Compliance Project
  - We have seen the IRS assess more intermediate sanctions penalties since 2011 than from 2004 through 2010

IRS Enforcement—Exams

- IRS uses incomparable data to determine reasonable compensation
- Actual examples:
  - The amount of compensation provided by an organization located in LA was compared to organizations located in: Kokomo, In; Bethany, OK; Tulsa, OK; Sioux City, IA; and South Portland, ME
  - The compensation of a fulltime CEO was compared to the compensation of CEOs working as “interim director,” executive director, “VP/Secretary,” and one individual with no listed title
  - In determining the average amount of compensation, in one IRS valuation, the IRS included an organization an organization that did not provide any compensation information for its president, and the report treated this as $0 in compensation for purposes of determining the average compensation for a position

IRS Enforcement—Recent Litigation

- Reason for Transaction
  - Organization was a tax-exempt educational counseling organization
  - CEO's wife was the majority owner of a business that provided back-end services related to the organization's counseling program
  - Largest donor decided to withhold all contributions until the organization dissolved the contractual relationship with back-end service provider
  - Organization decided that it could not continue to exist without the continued support of its largest donor

IRS Enforcement—Recent Litigation

- Facts Regarding Transaction
  - The time remaining on contract between the organization and Service provider was three years
  - The cost of breaching was estimated to be $2.2 million
  - At the time of the transaction, wife owed $600,000 from the purchase of the company
  - Without obtaining a formal valuation, wife agreed to sell the service provider to the organization for the amount that she owed to prevent a personal loss and ensure the organization's continued existence

IRS Enforcement—Recent Litigation

- IRS Position
  - The value of agreement was $0 because wife would not have sued an organization managed by her husband
  - Value of all assets, tangible and intangible, was $15,000 (the amount listed in the contract)
  - Wife received an excess benefit of $585,000
  - IRS issued a deficiency notice for $1.3 million, plus interest
  - IRS internal expert valuation

IRS Enforcement—Recent Litigation

- Facts During Litigation
  - Organization paid for two independent valuation reports, both demonstrated that the value of the company was in excess of $800,000
  - IRS internal expert determined that value was in excess of $700,000
  - IRS refused to consider the report of any expert and continued to assert that the value was $0

IRS Enforcement—Recent Litigation

- Results
  - After almost two years of litigation, the IRS settled the case by fully conceding the deficiency
  - The taxpayer was not required to pay any amount of taxes or penalties, but paid hundreds of thousands of dollars in legal fees
- Lessons
  - A valuation before the transaction could have prevented a lot of stress and saved a lot of money

Questions and Discussion

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