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IRC Section 4958 — A Big Hammer in the IRS Toolbox

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Not for profit entities must plan and document their executive compensation packages outlined in IRC Section 4958

To ensure that not for profit entities are being good stewards of their donors, or taxpayers' contributions, the IRS wields significant power to impose onerous penalties on over-compensated executives from 25% to 200% through the use of IRC Section 4958.

Compensation packages for college and university presidents, administrators and regents have been a very hot and divisive topic in California for the past few years, along with tuition hikes. In fact, Governor Brown threatened students with more tuition hikes if Proposition 30 (2013 retroactive personal income up to 13.3%) did not pass. It did, thanks in large part to many college-aged voters. Feeling the heat from students and parents, some university regents and presidents have actually reduced their compensation packages and/or foregone scheduled increases.

While IRC Section 4958's application to colleges and universities has been a recent focus of the IRS, this code section and the significant penalties have wide application to many other not for profit entities. Therefore, the management team of any not for profit or foundation must have a clear understanding of the rules and up-to-date written policies on how they award and monitor compensation packages, including reimbursed expenses

As mentioned in a recent Grant Thornton review, (see below), the financial penalties that colleges, universities, and other not for profit entities are potentially subject to are significant, but represent only one aspect of concern. For any high-profile

entity, the public embarrassment of IRS sanctions can create long-term issues for the not for profit, and the management team, including significant future fundraising challenges.

To better understand the magnitude of the financial penalties and the ways to avoid them, the following details may be useful to the not for profit management team and their advisors.

Excess Benefit Transaction

An excess benefit transaction is defined as an exchange that occurs between a "disqualified person" and applicable tax-exempt organization wherein the value received is less compared to the consideration given. The definition of a disqualified person is not limited to individuals who hold influential positions in a tax-exempt organization. It also extends to the members of their families or any companies where they control more than 35% of the entity. A disqualified person, under IRC section 4958, is required to pay an excise tax of 25% on the "excess" benefit received and if no corrective actions are done within the taxable period, an additional punitive excise tax equal to 200 percent of the excess benefit is imposed.

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IRC Section 4958 Background

In 1996, the biggest change in the taxation of charitable organizations took effect when Congress passed IRC 4958 known as the Intermediate Sanctions Legislation. These provisions levy a tax on excess benefit transactions for those organizations which are otherwise exempt from taxation under Internal Revenue Code §§ 501(c)(3) or 501(c)(4). Some organizations that fall under the umbrella of §501(c)(3) are religious, educational, charitable, scientific and literary organizations, while §501(c)(4) deals with civic leagues, social welfare organizations and local associations of employees. Before Congress passed IRC §4958, the IRS discouraged corruption in the charitable sector by threatening to, or actually revoking, the tax exempt status of an organization. However, the IRS realized that rather than taking down the whole organization, which may be doing very good things in the community, they should be going after specific people who are taking advantage of the organization and its supporters.

Preventative Measures

The Rebuttable Presumption is the best way to comply with intermediate sanctions. The following steps can be taken to meet this threshold:

- The compensation-setting body, comprised of the Board of Directors or trustees, or other governing body should approve the compensation packages ***in advance***. In addition, members of the compensation-setting body should only be parties that will not be receiving benefits under the program they are establishing.

- Similar to what Grant Thornton stated, same-level positions might entail different duties and responsibilities for different institutions, so simply comparing your compensation package to another might not be an accurate way to determine the reasonableness of your compensation estimate. Your comparison assessment should take into

consideration industry surveys, executive's experience level, size of the organization, and whether compensation includes severance or other payments for prior service in the organization, etc.

- Most importantly, the authorized body must provide a written record of the terms of the approved transaction and approval date in a timely manner. The document should specify the members of the decision-making body who took part during the deliberation process of the compensation packages. It should also describe the data that was used as a basis of the compensation package and how they acquired the information available.

Correcting Excess Compensation

One of the remedies available to the violating organization is to abate or correct the excess benefits. If the disqualified person reimburses the deemed excess benefit within a taxable period, then any 25 percent tax and related penalties imposed will be abated. However, the taxpayer must prove that excess benefits received were due to "reasonable cause" and not because of "willful neglect". Therefore, documentation is the key to reducing your exposure to these onerous provisions.

In summary, these provisions are a powerful tool for the IRS to ensure that the general public is protected and the management of the tax exempt entities are being good stewards of the entity's assets.

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