Intermediate Sanctions: Current Issues

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Intermediate Sanctions: Why They Still Matter

- Expansion of IRS authority
- Sought in audits
- Enforceable
- Public record: Form 990 disclosure
- Tax-exempt bonds compliance
- Board fiduciary duty
- Personal liability of directors
- Real money
Intermediate Sanctions: The Statutory Scheme

- With the enactment of the Taxpayer Bill of Rights 2 (H.R. 2337) on July 30, 1996, the Internal Revenue Code was amended to provide for intermediate sanctions for transactions between certain tax-exempt organizations and persons who can exert substantial influence over those organizations when the transactions result in an excessive benefit to such persons. They are “intermediate” in that they lie between taking no action and revoking an organization’s tax exemption.

- The rules have at their heart the excess benefit transaction. In the instance of one of these transactions, tax sanctions may be imposed on the disqualified persons who improperly benefited from the transaction and on organization managers who participated in the transaction knowing that it was improper.

- These sanctions apply to public charities (section 501(c)(3) charitable organizations other than private foundations) and tax-exempt social welfare organizations (those described in section 501(c)(4)). These entities are termed, for this purpose, “applicable tax-exempt organizations.” These entities include any organization described in one of the two categories of exempt organizations at any time during the five-year period ending on the date of the transaction.

- The Affordable Care Act added qualified nonprofit health insurance issuers to the statutory definition of applicable tax-exempt organizations.
Intermediate Sanctions: The Statutory Scheme

An excess benefit transaction is 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 the benefit.

- Compensation
- Purchase of goods and services
- Sale of goods and services

For these purposes, the term “disqualified person” means:

1. any individual who was, at any time during the five-year period ending on the date of the transaction involved, in a position to exercise substantial influence over the affairs of the organization (whether by virtue of being an organization manager or otherwise),
2. a member of the family of an individual described in the preceding category, and
3. an entity in which persons described in the preceding two categories own more than 35% of an interest. The Final Regulations make clear that a physician must be in a position to exercise substantial influence over the affairs of a healthcare organization to qualify as a disqualified person; merely being a member of the medical staff will not result in such a classification.
Intermediate Sanctions: The Statutory Scheme

- A disqualified person who benefited from an excess benefit transaction is subject to an initial tax equal to 25% of the amount of the excess benefit. An organization manager who participated in an excess benefit transaction, knowing that it was such a transaction, is subject to an initial tax of 10% of the excess benefit (subject to a maximum tax as to a transaction of $20,000), where an initial tax is imposed on a disqualified person. An additional tax may be imposed on a disqualified person if there was no correction of the excess benefit transaction within a specified time period. In this case, the disqualified person would be subject to a tax equal to 200% of the excess benefit involved.

Intermediate Sanctions: The Statutory Scheme

- An “organization manager” is a trustee, director, or officer of the organization, as well as an individual having powers or responsibilities similar to those of trustees, directors, or officers of the organization.
Intermediate Sanctions: The Statutory Scheme

- In applying existing tax law standards in determining reasonableness of compensation, there is a rebuttable presumption of reasonableness which arises where a compensation arrangement with a disqualified person was approved by an independent board (or an independent committee authorized by the board) that:
  1. was composed entirely of individuals unrelated to and not subject to the control of the disqualified person(s) involved in the arrangement,
  2. obtained and relied upon appropriate data as to comparability, and
  3. adequately documented the basis for its determination (for example, the record includes an evaluation of the individual whose compensation was being established and the basis for determining that the individual’s compensation was reasonable in light of that evaluation and data).
- If these three criteria are satisfied, penalty excise taxes could be imposed only if the IRS develops sufficient contrary evidence to rebut the probative value of the evidence put forth by the parties to the transaction.

Intermediate Sanctions: The Statutory Scheme

- When the IRS is determining whether an excess benefit transaction has occurred, all consideration and benefits exchanged between a disqualified person and the exempt organization and all entities the exempt organization controls are taken into account. Reg. 53.4958-4(a)(1).
Intermediate Sanctions: The Statutory Scheme

- Under the intermediate sanctions rules, a tax-exempt organization (or an exempt entity controlled by the organization) is treated as clearly indicating its intent to treat an economic benefit as compensation for services only if the exempt organization provided written substantiation that is contemporaneous with the transfer of the particular benefit. Reg. 53.4958-4(c)(1).

- If these substantiation requirements are not met, the exempt organization has the burden of establishing that it provided the economic benefit in exchange for consideration other than the performance of services (for example, a bona fide loan). If that burden is not met, IRS agents are instructed to treat the economic benefit as an “automatic” excess benefit transaction without regard to whether the economic benefit is reasonable; any other compensation the disqualified person may have received is reasonable; or the aggregate of the economic benefit and any other compensation the disqualified person may have received is reasonable. Reg. 53.4958-4(c)(1).

Intermediate Sanctions: The Statutory Scheme

- These intermediate sanctions generally are effective for transactions entered into on or after September 14, 1995 (other than transactions pursuant to written contracts binding on September 13, 1995 and thereafter). In general, intermediate sanctions will be the sole sanctions imposed in cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or other tax-exempt organization.
Intermediate Sanctions: The Statutory Scheme

- In the Pension Protection Act of 2006, Congress added several new situations that can result in automatic excess benefit transaction treatment under Code section 4958. The PPA creates a new rule for supporting organization-type public charities (section 509(a)(3) organizations, whether Type I, II, or III), that is analogous to the self-dealing rules that apply to private foundations. Under the provision, if a section 509(a)(3) supporting organization (Type I, Type II, or Type III) makes a grant, loan, payment of compensation, expense reimbursement or other similar payment to a substantial contributor (or person related to the substantial contributor) of the supporting organization, then for purposes of the excess benefit transaction rules, the substantial contributor is treated as a disqualified person and the payment is treated automatically as an excess benefit transaction with the entire amount of the payment (not just the portion that is greater than FMV) being the excess benefit.

Intermediate Sanctions: The Statutory Scheme

- In addition, loans by any supporting organization (Type I, Type II, or Type III) to a disqualified person (as defined in section 4958) of the supporting organization are treated as an excess benefit transaction under section 4958 and the entire amount of the loan is treated as an excess benefit. For this purpose, a disqualified person does not include a public charity (other than a supporting organization). These excess benefit transaction provisions apply to transactions occurring after July 25, 2006.
Intermediate Sanctions: QNHII- 501(c)(29)

- Section 1322 of the Affordable Care Act (ACA) requires Health and Human Services (HHS) to establish the Consumer Operated and Oriented Plan program (CO-OP program). Its purpose is to foster the creation of qualified nonprofit health insurance issuers to offer qualified health plans in individual and small group markets.

- Section 1322(h) of the ACA added § 501(c)(29) to the Internal Revenue Code. Section 501(c)(29) sets out rules for tax-exemption under § 501(a) of the Code for a qualified nonprofit health insurance issuer that has received a grant or loan under the CO-OP program.

- Section 1322(h)(3) of the Affordable Care Act amended § 4958(e)(1) to provide that an organization described in § 501(c)(29) is an “applicable tax-exempt organization” subject to § 4958.


Intermediate Sanctions: Form 990 Disclosures
Intermediate Sanctions: Form 990 Disclosures

Executive Compensation in the Spotlight

- Who’s Watching?
  - Internal Revenue Service
  - House Ways and Means/Senate Finance
  - State Legislatures
  - State Attorneys General
  - Charity Watchdog Groups
  - Media
  - Staff
  - Funders and Donors
  - Anyone with a Computer
Intermediate Sanctions: Executive Compensation

- Initial contract exception
- What counts as compensation
  - Regulations at Reg. 53.4958-4.
  - Form 990 reporting/instructions for Line 1, Part VII, Section A (Instr., p. 29)
- Catch-up salary adjustments
- Vesting of deferred compensation
- Loans
- Gratitude vacations and lovely parting gifts
- Automatic Excess Benefit Transactions
- Use of rebuttable presumption of reasonableness
  - When needed
  - Issues in determining reasonableness
  - Recordkeeping

Intermediate Sanctions: Physician Compensation

- Initial contract exception
- What counts as compensation
- Comparables
- Recruitment and retention arrangements
- Automatic Excess Benefit Transactions
Executive Compensation in the Spotlight

- In addition to the size of base salary paid to nonprofit executives, other practices are being questioned
  - Supplemental Executive Retirement Plans (SERPs)
  - Travel and Entertainment
  - Club Memberships
  - Executive Loans
  - Spousal Travel
  - Housing

Executive Compensation in the Spotlight

- Personal use of exempt organization assets
  - Cell phones
  - Computers
  - Cars
  - Boats
  - Vacation homes
ACA Restrictions on Executive Compensation

- Section 9014(a) of the Affordable Care Act (ACA) adds Section 162(m)(6) to Internal Revenue Code.
- Section 162(m)(6) limits the allowable deduction (as an ordinary and necessary business expense) to $500,000 for “applicable individual remuneration” and “deferred deduction remuneration” attributable to services performed by “applicable individuals” that is otherwise deductible by a “covered health insurance provider” in taxable years beginning after December 31, 2012.
- IRS issues Notice 2011-02 to interpret application of statute.
- Language is more restrictive than similar rule under Section 162(m) for publicly held corporations, lower dollar limit, no exceptions.
- May apply to more executives and more types of entities than originally anticipated.

Loan Phase of IRS Compensation Initiative

200 Compliance Check Letters
50 Single Issue Examinations
134 exams from Compliance checks
Started end of March, 2006
Executive Loan Issues

- Abuses
- Sarbanes-Oxley Act of 2002
- State nonprofit corporation code prohibitions
- IRS guidance (HAG; Rev. Rul. 97-21)
- PPA of 2006
  - Supporting organization loans to disqualified persons are AEBTs
- Best practices

IRS Single Issue Audit

- How you established compensation
- Duties and responsibilities of persons listed in Part V
- Do you intend to establish the rebuttable presumption?
- Did Board approve compensation? Provide copy of the approval and any employment contracts or agreements
- Does the compensation reported agree with W-2’s or 1099’s issued?
- Did individuals use organization’s property for any purpose other than to further the organization’s exempt purpose? Was this reported as compensation on W-2 or 1099?
Board Review Best Practices
- Substantial conflict of interest policy
- Rebuttable presumption of reasonableness
- Independent Compensation Committee
- Independent Audit Committee
- Full Board approval of CEO compensation, periodic review of staff compensation program
- Know your Form 990
- Know your disqualified persons

Compensation Compliance Strategies
- Avoiding Automatic Excess Benefit Transactions (AEBTs)
  - Use accountable plans
  - Avoid unrestricted per diems
  - Treat all benefits as compensation unless within an exception
  - No supporting org loans to disqualified persons or comp to substantial contributors
  - Reporting issues
Personal Liability for Directors

- Breach of fiduciary duty
- Fraud
- Gross negligence
- Tortious conduct
- Violation of law
  - E.g., state corporation law on loans; intermediate sanctions law
  - Knowing and willful

IRS Form 990-Schedule J-Compensation Information

1a Check the appropriate box(es) if the organization provided any of the following to or for a person listed in Form 990, Part VII, Section A, line 1a. Complete Part III to provide any relevant information regarding these items.
- First-class or charter travel
- Housing allowance or residence for personal use
- Travel for companions
- Payments for business use of personal residence
- Tax indemnification and gross-up payments
- Health or social club dues or initiation fees
- Discretionary spending account
- Personal services (e.g., maid, chauffeur, chef)

3 Indicate which, if any, of the following the filing organization used to establish the compensation of the organization’s CEO/Executive Director. Check all that apply. Do not check any boxes for methods used by a related organization to establish compensation of the CEO/Executive Director. Explain in Part III.
- Compensation committee
- Written employment contract
- Independent compensation consultant
- Compensation survey or study
- Form 990 of other organizations
- Approval by the board or compensation committee
State Efforts To Protect Against Excessive Compensation

- California
- Massachusetts
- Rhode Island
- New York
- New Hampshire

Massachusetts Attorney General on Compensation

- Initial warnings on executive and director healthcare compensation in 2009
  AG’s office increasing its oversight of executive and director compensation policies through periodic examination of practices, procedures, and outcomes

- “Today’s announcement should not be construed as an attempt to substitute the judgment of the Division for that of committed, knowledgeable and diligent boards…Our most effective managers will be and should be fairly compensated and we acknowledge that the results of the most perfect of compensation systems will be found offensive by some…Nevertheless, unless this Division and our charitable boards address these issues head on, particularly given recent economic trends and the serious crisis in health care costs, the discretion now vested in our boards is more and more likely to be subjected to far more dramatic externally imposed limits and controls.”
Massachusetts Attorney General on Compensation

- Of four health plans identified in 2009, Blue Cross Blue Shield of Massachusetts and Fallon Community Health Plan each voted to indefinitely suspend director compensation.
  - AG: "We applaud their decision and believe it provides an opportunity for a more thoughtful and considered analysis of the practice."

- The Boards of Tufts Health Plan and Harvard Pilgrim Health Care advised AG that they intend to continue the practice of compensating directors.
  - AG: "We are disappointed in their decisions and believe they are ill-advised…compensation of independent directors is not merely an issue of cost. Compensation has the potential to impair board independence."
  - AG: "Because compensating independent directors departs from the charitable industry and judicially recognized norm and creates unavoidable conflicts of interest, public charities that undertake this practice should do so only if they have a sound and convincing rationale."

Massachusetts Attorney General on Compensation

- AG announces two actions in response:
  - "Commencing in 2012, the office will require annual statements from all Massachusetts based public charities that compensate independent directors setting forth, in detail, the basis and rationale for the practice. In the interest of greater transparency, those statements, director compensation levels, and our evaluations, will form the basis of an annual public report by this office."
  - "We are filing legislation to authorize our office to prohibit your organizations from continuing to compensate directors without proper oversight. This legislation requires Massachusetts-based charities that intend to compensate their directors to receive approval from this office prior to undertaking this practice and therefore ensure that only charities that have a clear and convincing rationale for compensating directors may do so. Charities that have failed to justify the practice will be prohibited from doing so."
Case Study: Stevens Institute of Technology

- Venerable institution, 140 years old
- Large growth in endowment
- Popular and successful president
- Desire to provide financial reward to president for success and lack of rewards in prior years
- The Lake Woebegone Effect
- Autocratic board chair/insular executive and compensation committees
- Warnings to Board by auditors
- Two-year investigation by State AG (IRS too); AG demands changes, board refuses to acquiesce; AG brings suit

Case Study: Stevens Institute of Technology

- State court claims: breach of fiduciary duty; violation of UMIFA (excessive spending and portfolio lack of diversification); excessive compensation; mismanagement of endowment funds; gross negligence
- Stevens countersues alleging AG cannot substitute her judgment for the Board’s judgment
- Stevens agrees to Consent Agreement; president agrees to step down
- Stevens agrees to governance reforms: redistributes power from executive committee to full board; more independence; term limits; use of outside monitor and independent consultants; hiring of in-house counsel
Intermediate Sanctions

- Additional Case Studies
- Questions