

April 9, 2004

IRS Announces Enforcement Program for Intermediate Sanctions Involving Exempt Organizations

Will the IRS be Calling You?

On March 17, a senior “headquarters” official at the Internal Revenue Service in Washington, D.C., announced that the IRS will soon (within two weeks from the date of the announcement) launch an enforcement program aimed at improving compliance by tax-exempt organizations with the intermediate sanctions rules. These rules apply to all Section 501(c)(4) organizations and Section 501(c)(3) organizations, except private foundations. The official who made the announcement is in charge of developing IRS enforcement measures for these provisions (section 4958 of the Internal Revenue Code). The central feature of the program will involve the IRS contacting exempt organizations and conducting thorough examinations to determine how they are setting compensation and whether they are correctly reporting that compensation on annual Form 990 information returns. The IRS expects to contact hundreds of exempt organizations this year for an explanation of reporting positions that have been taken on Form 990, including a thorough analysis of how compensation decisions are made.

In making this announcement, it became evident that the IRS has been dissatisfied with the manner in which compensation for highly compensated employees has been reported by many exempt organizations. It was noted that many Forms 990 appear to have included incomplete or inaccurate information concerning compensation arrangements, and that, in many cases, officers and directors of exempt organizations also do not accurately report the amounts of compensation they receive on their own personal income tax returns. One problem on Form 990 is including all compensation from a primary organization and all of its affiliates in a related group, as is required in the instructions for Form 990. The focus will be on assuring that there is complete and accurate information in response to specific questions on Form 990 and required explanatory attachments.

The Intermediate Sanctions Rules

The intermediate sanctions taxes are not imposed directly against tax-exempt organizations, but rather against senior executives, board members and other highly compensated employees in a position to exert substantial influence over the activities of the organization (and who, accordingly, are classified as “disqualified persons”). The taxes usually are imposed only if disqualified persons use their influence to obtain excessive compensation or other economic benefits. In some cases, however, as a consequence of the mere failure of proper documentation, the IRS has assessed these taxes even in cases where the amount of compensation or economic benefits provided are not excessive (so-called “automatic” excess benefit transactions).

There is no question that over the past few years there were many signs that the IRS had a keen interest in the enforcement of the intermediate sanctions provisions, and has allocated specific compliance resources to that end. There have been repeated public statements by IRS representatives over the last two years, and a significant number of articles written concerning this subject, both for the purpose of training examining agents in the field and giving notice to exempt organization advisors about the IRS compliance initiative. For example, in a somewhat unusual departure from common practice, even the Director of the Exempt Organizations Technical Division, Steven T.

Miller, has written articles emphasizing the importance of intermediate sanctions compliance, and recommending the implementation of relatively simple compliance procedures to serve as a virtually automatic protection mechanism.

A key requirement for application of the intermediate sanctions rules is participation in a transaction or arrangement by a disqualified person. In many cases, the determination of whether a person will be treated as a disqualified person is easily made. However, because (in addition to several categories of *per se* disqualified persons) there is also a broader category based on analysis of a series of facts and circumstances identified in the regulations as tending to show that a person either is, or is not, a disqualified person, in a number of cases the correct classification may be ambiguous. For this and other reasons, the adoption and use of systematic, and non-burdensome compliance procedures is highly recommended. Fortunately in this regard, the intermediate sanctions regulations provide a “rebuttable presumption of reasonableness” that serves as an effective compliance mechanism if properly adopted and applied. There may be some initial cost in setting up appropriate procedures (including essential record-keeping procedures) in order to be positioned to satisfy all or as many as possible of the requirements for qualification for the rebuttable presumption of reasonableness. Nevertheless, doing so establishes virtually guaranteed compliance with the intermediate sanctions rules.

How We Can Help

Duane Morris has developed a complete package of services to audit exempt organizations, determine their vulnerability to intermediate sanctions and correct any deficiencies that are discovered. We also offer educational program materials for exempt organizations and their trustees, directors, officers and employees. We can also help if you receive a call from the IRS.

For additional information about intermediate sanctions compliance, the Duane Morris audit program or the IRS enforcement program, please contact David M. Flynn at 215.979.1947 or the lawyer in the firm with whom you are regularly in contact.