

PRESENTED AT

6th Annual Higher Education Taxation Institute

June 3-5, 2018

Austin, TX

Summary of Intermediate Sanction Rules for Private Colleges and Universities

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SUMMARY OF INTERMEDIATE SANCTION RULES FOR PRIVATE COLLEGES AND UNIVERSITIES

Section 501(c)(3) of the Internal Revenue Code ("Code") exempts entities organized and operated exclusively for religious, educational or charitable purposes from federal income tax. The exemption further provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or part to the benefit of private individuals.¹ To enforce this anti-private inurement rule short of revoking the tax-exempt status of the organization, Congress enacted Code Section 4958, referred to as the "intermediate sanction rules." Code Section 4958 imposes excise taxes on certain "disqualified persons" who receive an "excess benefit" from a Section 501(c)(3) organization and on the "organization managers" who approve or fail to disapprove such "excess benefit transactions."²

WHAT IS THE EXCISE TAX AND WHO PAYS IT?

The excise tax is paid by the individuals who benefitted from or approved the excess benefit transaction, and not by the tax-exempt organization.

- A "disqualified person" who receives an excess benefit is liable for an excise tax equal to 25% of the excess benefit if timely corrected and, if not timely corrected, an additional excise tax equal to 200% of the excess benefit.³
- Each "organization manager" who knowingly participates in the excess benefit transaction is liable for an excise tax equal to 10% of the excess benefit, with a maximum of \$20,000 per excess benefit transaction, unless the participation was not willful and was due to reasonable cause.⁴

If more than one disqualified person or organization manager is liable for the excise tax, liability is joint and several.⁵

WHAT IS AN EXCESS BENEFIT TRANSACTION?

An "excess benefit transaction" is any transaction in which the tax-exempt organization provides – *directly or indirectly* - an economic benefit to (or for use by) a disqualified person, if the value of the economic benefit exceeds the value of the consideration (*e.g.* the performance of services) received for providing the benefit.⁶ The amount by which the value of the economic benefit exceeds the value of the consideration is referred to as the "excess benefit."⁷ The excise tax is imposed upon the excess benefit.

¹ Treas. Reg. § 1.501(c)(3)-1(c)(2).

² The intermediate sanction rules do not apply to governmental entities, such as public universities, even if they also have 501(c)(3) status. Treas. Reg. § 53.4958-2(a)(2)(ii).

³ Treas. Reg. §§ 53.4958-1(a) & (c)(2).

⁴ Code §§ 4958(a)(2) & (d)(2); Treas. Reg. §§ 53.4958-1(d)(1) & (7).

⁵ Code § 4958(d)(1); Treas. Reg. §§ 53.4958-1(c)(1), (c)(2), & 1(d)(8).

⁶ Treas. Reg. §§ 53.4958-1(a) & -4(a)(1).

⁷ Treas. Reg. § 53.4958-1(b).

The most common form of excess benefit transaction is the payment of excessive compensation. Compensation for the performance of services is considered reasonable only if the amount paid would ordinarily be paid for like services by like enterprises (whether for-profit or non-profit) under like circumstances taking into account all economic benefits provided to the disqualified person.⁸ The Internal Revenue Service ("IRS") has looked at the following factors in determining the reasonableness of compensation:

- Whether the arrangement was made at arms-length;
- The size and complexity of the tax-exempt organization;
- The nature of the disqualified person's duties and responsibilities;
- The qualifications and prior compensation of the disqualified person;
- The performance of the disqualified person;
- The compensation scale for all employees of the tax-exempt organization;
- Whether an independent compensation committee made the compensation decision;
- Whether the compensation is comparable to compensation paid to other persons working in a similar capacity at similar organizations; and
- Whether there are adequate upper limits on compensation.⁹

The reasonableness of the compensation is determined at the time the contract is entered into for fixed payments, and based on all facts and circumstances up to the date of payment for non-fixed payments.¹⁰

Generally, all cash and non-cash compensation and benefits - whether taxable or non-taxable - exchanged between a disqualified person and a tax-exempt organization (and all organizations in the controlled group) are taken into account in determining if there has been an excess benefit transaction.¹¹ This includes bonuses, severance, vested deferred compensation, health and welfare plan premiums, and retirement plan contributions.¹² Deferred compensation subject to a substantial risk of forfeiture is taken into account for purposes of these rules at the time it vests.¹³ In determining the reasonableness of compensation that is paid or vests in a given year, services performed in prior

⁸ Treas. Reg. § 53.4958-4(b)(1)(ii).

⁹ See e.g., *Peters v. Comr.*, T.C. Docket No. 8446-00 (2000).

¹⁰ Treas. Reg. § 53.4958-4(b)(2).

¹¹ Treas. Reg. § 53.4958-4(a)(1).

¹² Treas. Reg. § 53.4958-4(b)(1)(ii)(B). Certain economic benefits are not taken into account for purposes of the intermediate sanction rules, including non-taxable fringe benefits, expense reimbursement payments made under an accountable plan, certain economic benefits provided to volunteers, certain economic benefits provided to donors if generally available; economic benefits provided to a charitable beneficiary, and transfer of economic benefit to a governmental unit for exclusively public purposes. Treas. Reg. § 53.4958-4(a)(4).

¹³ Treas. Reg. § 53.4958-1(e)(2).

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First appeared as part of the conference materials for the
6th Annual Higher Education Taxation Institute session

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