

“AUTOMATIC” EXCESS BENEFITS TRANSACTIONS: AVOIDING INTERMEDIATE SANCTIONS AND LOSS OF EXEMPT STATUS

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In January 2004, the Internal Revenue Service published a continuing professional article, *“Automatic” Excess Benefit Transactions Under IRC 4958*. The article provides guidance to help agents determine when compensation received by a disqualified person from a tax-exempt organization should be considered an “automatic” excess benefit transaction under Internal Revenue Code 4958. This guidance should be a wake-up call for exempt organizations that enter into compensation arrangements with their executives that may provide excess economic benefits.

Most exempt organizations focus on ensuring that compensation provided in these arrangements is “reasonable.” However, the IRS guidance emphasizes the equally great importance of written proof - the exempt organization must evidence its intent to treat economic benefits received by its executives as compensation. The IRS has clearly indicated that it will enforce the intermediate sanction regulations under section 4958 and will determine an excess benefit transaction has occurred, even if compensation is reasonable, if the organization fails to substantiate its intent to treat all economic benefits provided to the executives as compensation.

This article will discuss the elements of an excess benefits transaction, the reporting requirements of Form 4720, and the taxes and penalties involved in such a transaction. The article will also examine how the IRS dissects an organization’s evidence of substantiation and will review relevant IRS guidance, rulings, and tax court opinion. Finally, the article will discuss what steps the IRS is taking to enforce the intermediate sanction regulations and how exempt organizations can protect themselves from an imposition of intermediate sanction penalties.

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