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Automatic Excess Benefit Transactions

Did you know that if a 501(c)(3) public charity or a 501(c)(4) social welfare organization fails to properly substantiate payments that it makes to its insiders as either compensation or reimbursement, those payments may be subject to significant excise taxes?

Under Internal Revenue Code Section 4958, the IRS may impose intermediate sanctions on any “excess benefit transaction” between an applicable exempt organization and an insider of that organization.

The insider (a “disqualified person” under the Code) can be liable for a tax of 25 percent on any “excess benefit” received. If the excess benefit transaction is not corrected (e.g., any excess payment returned), a second-tier tax of 200 percent on the excess benefit is imposed. Officers and directors who approve the transaction also may have tax liability.

In reviewing insider compensation, the IRS typically aggregates all compensation provided for services and determines whether the overall compensation was reasonable.

However, the organization must clearly indicate its intent to treat a benefit as compensation at the time the benefit was paid. If the organization *fails* to substantiate that a compensatory benefit is being provided to the insider as compensation, the IRS will treat the payment as an “automatic” excess benefit transaction, which means the amount is taxable without regard to whether the benefit was reasonable.

This issue often arises when an organization provides certain **fringe benefits** but doesn’t report them as compensation. For instance, paying for spousal travel can be an excess benefit payment. Providing use of an employer’s vehicle also may qualify. In every case, the organization should determine whether it is reasonable to provide the benefit and, if provided, whether it must be reported as compensation.

One way to provide “written contemporaneous substantiation” that a payment was intended as compensation is by reporting the benefit to the IRS, either by the exempt organization (on Form 990, and Form W-2 or Form 1099) or the disqualified person (on Form 1040).

If the exempt organization did not report the benefit as compensation on its original Form 990, it is possible to amend a prior return to recognize the benefit as compensation, provided the amended return is filed before the start of an IRS examination of either the exempt organization or the disqualified person for the year when the transaction occurred.

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Nonprofit Law Matters looks at legal issues in the nonprofit and tax-exempt organizations world. Written by the attorneys and paralegals of Adler & Colvin, it provides updates and analysis regarding philanthropy, charity, and other exempt organization issues.

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Expense reimbursement also may result in an “automatic” excess benefit transaction, if not done properly. These payments should be made in compliance with an “accountable plan” (requiring that reimbursed expenses have a business connection, be properly documented, and that any excess amounts be returned within a reasonable amount of time). Payments that are not made under an “accountable plan” are included in the employee’s gross income, reported as wages or other compensation on the employee’s Form W-2, and subject to withholding and payment of employment taxes. If these amounts are not documented as compensation, they are also automatic excess benefits under Section 4958.

Automatic excess benefit transactions easily could be a source of potential tax liability in an IRS audit, for both the insiders receiving the benefit and possibly the officers and directors who approve the payments. In addition, the organization will have an obligation to attempt to correct the payments and will need to report that it was party to an excess benefit transaction on its Form 990, a public document, which the organization certainly will want to avoid.

For more on Section 4958, see <http://www.irs.gov/charities/charitable/article/0,,id=123298,00.html>.

For more on automatic excess benefit transactions, see <http://www.irs.gov/pub/irs-tege/eotopice04.pdf>.