

Article

**WHAT NONPROFIT BOARD MEMBERS AND MANAGERS
DON'T KNOW CAN HURT THEM FINANCIALLY:
IRS FORM 990 AND THE INTERMEDIATE SANCTIONS ACT**

EUGENE H. FRAM, ED.D¹

Nonprofit 501(C)(3) charitable organizations and 501(C)(4) social welfare organizations fall under two IRS regulations—the extended annual Form 990 and the Intermediate Sanctions Act (Act). Form 990 requires answers to 38 corporate questions on corporate governance operations. The Act covers prohibitions related to providing or seeking excess benefits. Most board members know about the Form 990, but few know about its board obligations; and few board members and managers know the Act exists. With the IRS aggressively enforcing the Act to eliminate faux nonprofits, unwitting nonprofit board directors and managers can become ensnared financially.

Two classes of nonprofit organizations, 501(C)(3) charitable organizations and 501(C)(4) social welfare organizations, are covered by two IRS regulations not applicable to for-profit corporations.

One regulation requires the organization to file an IRS Form 990 each year, including financial data plus answers to 38 questions related to corporate governance. Many board members may be unaware of their obligations to be involved in preparation of the form each year. If there were an audit involving the 38 board questions, further, board members might be expected to know about any exceptions to be reported, such as conflicts of interest. For example, any board member whose firm or employing firm has a business relationship with the nonprofit must specify it as a conflict of interest on Form 990 and probably abstain from voting on related issues. Also, if the report is late, the nonprofit must file an IRS form, and the board needs to be advised of the situation.

If the organization ignores any of the requirements, it can lose its tax-exempt status—a penalty already imposed on thousands of smaller nonprofits. In some instances, moreover, failure to heed the requirements might leave nonprofit board members open to personal liability for failing in their corporate duties for “due care.”

¹ Eugene H. Fram is Professor Emeritus, Saunders College of Business, Rochester Institute of Technology, and the author of the newly published *Going for Impact: The Nonprofit Director's Essential Guidebook*. He can be reached at 1 West Edith Ave – A103, Los Altos, California 94022, frameugene@gmail.com, blog <http://non-profit-management-dr-fram.com>.

The suggestions presented in this article are based on field observations as a veteran for-profit and nonprofit director and consultant. They should not be construed as offering legal advice.

Parts of this article contain revised and updated material from Eugene Fram & Elaine Spaul (2001) “Expectations for Nonprofit Boards are Changing,” *Nonprofit World*, May/June, and reflect the expertise of Elaine Spaul, Ph.D., J.D.

Another obligation to which nonprofits must adhere is the Intermediate Sanctions Act, Internal Revenue Code section 4958 (the Act). The Act was passed by Congress in 1996 with temporary rules of enforcement, but it was not robustly enforced until about 2002. Although they can be financially ensnared by the 20-year-old Act, very few nonprofit board members and managers seem to know it exists. In making conference presentations to nonprofit directors, CEOs, and managers, in fact, I find that ignorance of the law is frightening.

From press coverage and elsewhere, board members and managers are generally aware that their organizations can be in trouble if they pay unreasonable compensations. But they are unaware of other sections of the Act that can lead to personal liability for board members, senior managers, and even such tangential persons such as volunteers and vendors.

History of the Intermediate Sanctions Act.

Up to 1996, the IRS had only one tool to sanction nonprofit organizations that violated its regulations: It could revoke the organization's tax-exempt status, a difficult and costly legal process. Without fraud or a lack of "due care," the IRS was powerless to hold individual board members or managers financially responsible.² The need for the Act was prompted by several scandals in which CEOs and/or board members of high-profile organizations used their positions to unjustly enrich themselves.

To give the IRS a tool to target those responsible for such activity while allowing the nonprofits to retain their tax-exempt status and continue serving clients, Congress passed the Intermediate Sanctions Act. "The legislative history of section 4958 provides that intermediate sanctions ... may be imposed ... in lieu of, or addition to, revocation of and organizations tax-exempt status—H. Rep. No. 104-506."³

Importance of Excess Benefits and Disqualified Persons

The key to the Act is what one part of the legislation calls an *excess benefit*. An excess benefit can develop in ways other than paying above-market wages. The IRS may consider as excess benefits the nonprofit's above-market payment for an asset or its disadvantageous financial arrangements with other organizations. A fundraising group that receives an excessively generous travel budget from a nonprofit group can also be in violation of the Act. Those giving and those seeking an excess benefit can both be liable.

The Act also specifies who may be liable under its provisions, identified with the curious title of *disqualified persons*:

Disqualified persons include organization officers, board members and their relatives. [More importantly] the disqualified persons category also can be extended to people not on the staff or board if they are in a position to exercise substantial influence over the organization's affairs. For example, if a volunteer agrees to chair a program task force, that person may be considered a disqualified person. Major donors also may fall into this

² Even when charged by state regulators, one board refused to back down on an excess salary. See: <https://nonprofitquarterly.org/2014/08/04/trustees-of-queens-library-dismissed-after-defending-high-ceo-salary/>

³ David A. Levitt (2009) "Excess Benefit Transactions Under Section 4958 and Revocation of Tax-Exempt Status," *Practical Tax Lawyer*, spring.

category, even if their only role is to provide resources. The legal reasoning is that such people have the ability to exercise substantial influence over the organization.⁴

In simple terms, those receiving the benefit as well as board members and managers approving it are all subject to the Act.⁵

In addition, if some benefits are not included in the recipient's W-2, they are considered an *automatic* excess benefit that must be reported on the public IRS Form 990. As of 2008, the IRS has the power to revoke the organization's tax-exempt status if it is found guilty of one or more excess benefits transactions.⁶

Personal Tax Sanctions

The IRS levies penalties in an unusual way. They are added to the income tax bill of the individuals found responsible:

For example, if a section 501(C)(3) organization were found to have paid \$150,000 to a disqualified person in a transaction for which \$100,000 was fair market value, the disqualified person would have to pay a tax of 25% of \$50,000 or \$12,500 to the IRS. In addition the disqualified person would have to return the excess benefit of \$50,000 to the organization, or be subject to the 200 percent penalty tax (\$100,000).⁷

Enforcement of IRS 4958

To assess the level of enforcement of the Act, I contacted four practicing attorneys, two of whom specialize in actions related to the Intermediate Sanctions Act. Three cited only one court case related to a merger situation in which section 4958 was a primary issue.⁸ All agreed that the IRS is settling cases without litigation.

Two attorneys suggested that the IRS might be following a procedure common to administrative agencies:

- The agency identifies an action as a violation of a statute, sometimes with modest evidence.
- The agency proposes a settlement. If the accused agrees, the case is resolved.
- If the case is not resolved, the agency takes aggressive actions to obtain a settlement—sometimes euphemistically called “rattling the cage.”
- If there is no settlement, the agency submits the action for trial or concedes the case.

With so few court cases on record, those accused seem to be acquiescing in the charges. One hopes that all of these are nonprofits that have been established for self-interest.

⁴ Eugene Fram & Elaine Spaul (2001) “Expectations for Nonprofit Boards are Changing,” *Nonprofit World*, May/June.

⁵ David A. Levitt (2012) “Automatic Excess Benefit Transactions,” *Nonprofit Law Matters*, Adler & Colvin, March 22.

⁶ Levitt (2009).

⁷ Levitt (2009).

⁸ Carracci v. Commissioner, <http://caselaw.findlaw.com/us-5th-circuit/1147472.html>

Such a process, however, can easily ensnare well-meaning nonprofit directors, managers, or even volunteers who unwittingly approve an excess benefit. In my opinion, nonprofit directors with nontraditional backgrounds may face a particular risk. In some states, nonprofits such as medical facilities are required to have current or former clients on their boards, which could leave some low-income people facing significant tax liabilities. These persons can be placed in a precarious situation, especially if their D&O policies do not cover losses levied under the Act.

A Hypothetical Case

Following is a statement from a D&O policy that *does* cover the Act:

Costs of Defense incurred by the Insured. Loss shall not include: (1) criminal or civil fines or penalties imposed by law, or taxes (except for the 10% “excess benefit” tax assessed by the Internal Revenue Service against any Insured Person pursuant to 26 USC Section 4958 (a))

Would naïve volunteer board members who approve an excess benefit be covered under such a D&O policy? It is highly possible that an inept CFO and/or external auditor might be at fault for the IRS bringing an action.

The naïveté about the Act extends beyond untutored volunteer board members. I have encountered certified public accountants and attorneys, including one representing a national legal association, who had no idea the law existed. I have also encountered a competent CFO who had unintentionally failed to add an excess vacation benefit to an employee’s income. Fortunately, the auditing firm found the error. If it had not done so, the IRS could have deemed the error an automatic excess benefit. Obtaining a claim rescission would have entailed substantial legal costs and dedicated management time.

In sum, ignorance of the Intermediate Sanctions Act can be financially devastating to well-meaning people. Nonprofit board education is needed in the area. In particular, all board members ought to

- Be alert: Every board member should know that the Act covers much more than paying higher salaries and identifying disqualified persons. Well-meaning outsiders, such as donors and revenue-sharing organizations, could be deemed part of an operating partnership that might be ensnared by Section 4958.
- Know about compensation and benefits: Nonprofits frequently delegate compensation decisions regarding the executive director or CEO to the board chair or a few senior board members. The entire board should review all salary schedules every year. If questioned by the IRS, every board member should know the compensation of the three or five highest-paid persons. All of this needs to be completed before a salary increase is awarded.
- Make certain records are kept: If the organization is audited, it will need records of any transaction being questioned. Board members who are unsure whether a transaction might involve an excess benefit should ask the board to seek competent legal counsel. The existence of an excess benefit may fall in a gray area. It could well be fact-based, in light of practices of comparable organizations. But counsel could flag whether the potential exists for the payment or benefit to be deemed an excess benefit. If the board refuses to accept the view of counsel, board members who might perceive it to be an

excess benefit should vote “no” on the transaction and make certain their votes are clearly recorded in the meeting minutes in order to avoid liability. When in danger of approving an excess benefit, it is not a good idea “to go along to get along,” a culture that seems to pervade nonprofit boards.

- Know about safe harbor provisions: The IRS says boards should take certain actions before making any decision that might be construed as involving an excess benefit—for example, using organization funds to support an executive director’s trip to Europe after 20 years of service. The board should first appoint a group of disinterested board members or a formal board committee of disinterested persons to approve such a transaction, and it should ensure that the group’s decision rests on comparable data gathered by disinterested field experts. For the European trip, it would be best to determine if such a reward were standard industry practice, in case the IRS questions the transaction.
- Make certain all directors’ and officers’ D&O liability insurance policies cover excess-benefit tax sanctions. If not, they should seek coverage. Some policies may exclude indemnity coverage where there is a violation of law.
- Make certain that the annual conflict of interest statement signed by board members, managers and other disqualified persons includes some reference to the Intermediate Sanctions Act.
- Have counsel review appropriate bylaws, operating guidelines, principles or policies, etc., to make certain that all compensation processes and other major transactions comply with the Intermediate Sanctions Act.