Strategic Alert #60

Date: April 15, 2002 (Revised August 30, 2004)

To: Licensees for Loan-Based Deferred Compensation System (previously named Leveraged Compensation Plan System)

From: Robert B. Ritter, Jr.

Re: IRS Issues Final Intermediate Sanctions Regulations for Excess Benefit Transactions between Exempt Organizations and Their Managers or Other Insiders.

Final Regulations: Intermediate Sanctions

The IRS has final regulations implementing the "Intermediate Sanctions" legislation passed in 1996 as IRC Sec. 4958. This new Code section could impose excise taxes on participants in Loan-Based Deferred Compensation ("LB-DC") arrangements provided by public charities (Sec. 501(c) (3) and Sec. 501(c)(4) organizations that are not private foundations) unless precautions are taken to document that the plan contributions (when taken together with other benefits and compensation) are reasonable compensation for the services rendered by the participant.

The final regulations contain few changes from the Temporary and Proposed Regulations published in January 2001. They are helpful in that they spell out guidelines for an exempt organization to create a "rebuttable presumption" that an arrangement such as LCP is in fact reasonable. When a rebuttable presumption exists, the IRS has the burden of proving the transaction is unreasonable, an uphill battle if there is documentation that the organization exercised care and prudence in the decision-making process. The final regulations create a rebuttable presumption that compensation is reasonable -- and not subject to the excise taxes of Sec. 4958 -- where:

1) The compensation arrangement or the terms of the property transfer are approved in advance by an authorized body (usually the Board of Directors, or a committee thereof) of the applicable tax-exempt organization composed entirely of individuals who do not have a conflict of interest with respect to the compensation;

2) The authorized body obtained and relied upon “appropriate data” as to comparability prior to making its determination; and
3) The authorized body adequately documented (as provided in the regulations) the basis for its determination concurrently with making that determination.

Tax exempt organizations have been subjected to increased scrutiny in recent years, including scrutiny over the issue of excessive compensation as private inurement. However, the safe harbor contained in the final regulations for IRC Sec. 4958 outlined above should enable most tax exempt organizations to protect themselves, their executives, and their LB-DC arrangements from the intermediate sanctions rules.

If, as is typically the case with our approach to LB-DC, the executive pays the loan interest associated with the plan and the employer offsets all or part of that loan interest with a bonus, that bonus -- not the loan amount -- should be the compensation amount to which IRC Section 4958 discussed above should apply.

A copy of the final regulations (T.D. 8978; Reg. §53.4958-0 through 53.4958-7, 67 Fed. Reg. Pgs. 3076-3099; January 23, 2002) can be obtained from the LB-DC page of our website. From InsMark’s home page, www.insmark.com, choose Producer’s Center, then Product Center, then Loan-Based Split Dollar, or **click here** to link directly.

InsMark’s Loan-Based Deferred Compensation System has been welcomed by both tax exempt organizations and taxable entities as a method of providing valuable benefits to highly prized executives.

Important Notice

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