



Unreasonable Compensation - Tax Exempt Organizations
by
Richard C. Baier J.D., CLU, ChFC, FLMI, Author of the Documents
in
InsMark's Documents On A Disk[®] and Documents On The Net[™]

Published January 23, 2002, in the Federal Register, the IRS released its 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 benefit arrangements such as those illustrated in InsMark's Leveraged Compensation System ("this Plan") provided by public charities unless precautions are taken to document that plan contributions (when taken together with other benefits and compensation) are reasonable compensation for the services rendered by the participant. Section 4958 applies to Sec. 501(c)(3) and Sec. 501(c)(4) organizations that are not private foundations (which are governed by other Code Sections).

Specifically, the statute imposes a tax on any "disqualified person" for each "excess benefit transaction". The tax is equal to 25% of the amount of the excess benefit. A "disqualified person" is any person "in a position to exercise substantial influence over the affairs of the organization", a member of that person's family, or certain business entities with 35% or more controlled by a disqualified person. An "excess benefit transaction" can include any transaction with a disqualified person in which the value of the economic benefit provided to him or her exceeds the value of the service or other consideration received from him or her. In the context of this Plan, however, the provision would apply to payments of insurance premiums deemed to be "unreasonable compensation".

With the typical use of this Plan, the arrangement is funded via an executive's compensation adjustment which, using loan regime split dollar principles, the employer uses to fund a loan to the executive in an amount equal to all or part of the premium of a life insurance policy. If the executive pays the loan interest associated with this 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.

With one of the variations of this Plan, an employer provides a bonus to the employee equal to the premium on a life insurance policy and extends split dollar loans to cover the income tax on the bonus. If the executive pays the loan interest associated with this Plan and the employer offsets all or part of that loan interest with a bonus, that bonus -- not the loan amount -- along with the bonuses for premium payment should be the compensation amount to which IRC Section 4958 discussed above should apply.

Note: IRC Section 4958 could also apply to a bonus rollout of the loans associated with variations of this Plan. Since there is no formal deferred compensation agreement (to avoid having this Plan fall under the restrictions of Section 457), the reasonableness of the compensation will need to be documented for the year of the rollout (or the rollout could perhaps be made in consideration of a post-retirement consulting agreement and released over a number of years).

This may appear problematical if this Plan is funded entirely from the executive's foregone compensation; however, the efficiency of having the funds in this Plan operate at the organization's 0% tax bracket rather than being shaved by the executive's 30%+ bracket. This will normally create more than enough leverage to offset a possible forced forfeiture by the executive of his/her original funds. Alternatively, the organization could contribute its own funds (within reasonable compensation guidelines) to offset the executive's loss.

Note: A Severance Agreement of a reasonable amount that would take effect only in the event of involuntary termination might also be a useful device to "refund" the executive's compensation adjustments associated with variations of this Plan.

If the excess benefit transaction is not "corrected" within a specified period, the tax payable by the disqualified person increases to 200% of the excess benefit. Furthermore, participation in the excess benefit transaction by any organization manager in which the manager knows that it is an excess benefit transaction (unless the participation is not willful and is due to a reasonable cause) subjects the manager to an excise tax equal to 10% of the excess benefit (to a maximum of \$10,000 for each occurrence).

The final regulations contain few changes from the Temporary and Proposed Regulations published in January 2001. One particularly useful section, however, gives guidelines for an exempt organization to create a "rebuttable presumption" that an arrangement such as this Plan is in fact reasonable. When a rebuttable presumption exists, the IRS has the burden of proving the transaction is unreasonable, an uphill battle for the Service 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:

- ✓ 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;
- ✓ The authorized body obtained and relied upon "appropriate data" as to comparability prior to making its determination; and
- ✓ 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 and outlined above should enable many organizations to protect themselves, their executives, and their benefit arrangements from the intermediate sanctions rules.

Specimen Documentation

Specimen documentation for variations of this Plan are available in Version 19.0 (and higher) of InsMark's Documents On a Disk[®] and Documents On The Net[™]. See the document set entitled "Leveraged Deferred Compensation Using Loan Regime Split Dollar (Tax Exempt Organization)" in the Employer-Sponsored Split Dollar section of documents and the document set entitled "Leveraged Executive Bonus (With Loan Regime Collateral Assignment Split Dollar to Pay Tax on Bonus)" in the Executive Bonus Plans section of documents.

Important Notice

This information in this report is for educational purposes only. In all cases, the approval of a client's legal and tax advisers must be secured regarding the implementation or modification of any of the planning techniques discussed as well as the applicability and consequences of other cases, rulings, or legislation upon existing or impending plans.

IRS Circular 230 Disclosure

In order to comply with requirements imposed by the IRS which may apply to this document (including any attachments, enclosures, or referred material) as distributed or as re-circulated, please be advised that the material contained herein is not intended or written to be used, and it cannot be used, by anyone for the purposes of avoiding any penalty that may be imposed by the Internal Revenue Service under the Internal Revenue Code. In the event that this document (including any attachments, enclosures, or referred material) is also considered to be a "marketed opinion" within the meaning of the IRS guidance, then, as required by the IRS, please be further advised that the material contained herein is written to support the promotions or marketing of the transactions or matters addressed by the material contained herein, and, based on the particular circumstances, you should seek advice from an independent tax advisor.