Guide to intermediate sanctions for not-for-profit executive compensation
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Introduction

Intermediate sanctions are a personal excise tax paid by “disqualified persons” (executives such as CEOs, COOs and CFOs) who provide services to a section 501(c)(3) or 501(c)(4) organization and receive unreasonable compensation. A personal excise tax is also paid by the individuals who participated in the decision to pay the compensation, such as board members.

Grant Thornton LLP has prepared this comprehensive guide to help you understand the intermediate sanctions rules. The guide provides information on:

- Identifying individuals who are subject to intermediate sanctions
- Determining whether compensation paid to disqualified persons is reasonable
- Managing the risk of intermediate sanctions
- Deciding whether to undertake an intermediate sanctions study
- Determining the steps involved in an intermediate sanctions study
What are intermediate sanctions?

The excise tax on disqualified persons is 25% of the “excess benefit” (i.e., the amount of compensation that is unreasonable), with an additional 200% tax if the executive does not return the excess benefit to the organization. The excise tax on the individuals who participate in the decision-making process is 10% of the excess benefit, with a maximum tax of $20,000 for each excess benefit transaction.

The intermediate sanctions regulations define reasonable compensation as the “amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances.” Thus, any amount in excess of this amount is unreasonable compensation and treated as an “excess benefit.” Further details regarding the definition of reasonable compensation are provided under the subheading, “How is reasonable compensation for a disqualified person determined under the regulations?”
What is the definition of a disqualified person?

**Summary**
A disqualified person is any person who was at any time during the preceding five-year period in a position to exercise substantial influence over either:

- The affairs of your entire organization
- A discrete segment or activity of your organization that represents a substantial portion of your activities, assets, income or expenses

The individuals with the following titles are presumed to be disqualified persons:

- CEO
- President
- COO
- CFO
- Treasurer

In addition, individuals who have ultimate responsibility for the following duties are disqualified persons, regardless of their title:

- Implementing the decisions of the board
- Supervising the management, administration or operation of the organization
- Managing the finances of the organization

Board members who have voting rights are also disqualified persons.

Appendix A contains a worksheet for identifying disqualified persons.

**Details**
Disqualified persons are defined in section 4958(f)(1) and Treas. Reg. § 53.4958-3 as any of the following individuals or entities:

1. Any person who was at any time during the preceding five-year period in a position to exercise substantial influence over the affairs of the organization.

2. The following family members of a person described above:
   - Spouse
   - Ancestors (e.g., parents, grandparents, great-grandparents)
   - Children, grandchildren and great-grandchildren
   - Spouses of children, grandchildren and great-grandchildren
   - Brothers and sisters and their spouses

3. A 35% controlled entity, defined as:
   - A corporation in which the persons described in item 1 own more than 35% of the total combined voting power or
   - A partnership in which the persons described in item 1 own more than 35% of the profits interests or
   - A trust or estate in which the persons described in item 1 own more than 35% of the beneficial interests

4. For a donor-advised fund, as defined under section 4966(d)(2), a donor or any person appointed or designated by the donor, who has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the fund. This includes members of the individual’s family, as well as any entities over which the individual has 35% or more control, as described in item 2.
For a sponsoring organization, as defined under section 4966(d)(1), an investment adviser, as defined in section 4958(f)(8)(B), is “any person (other than an employee of such organization) compensated by such organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor-advised funds ... owned by such organization.” This includes members of the individual’s family, as well as any entities over which the individual has 35% or more control, as described in item 2.

Under Treas. Reg. § 53.4958-3(c), the following individuals are treated as disqualified persons, unless it can be demonstrated that they do not exercise substantial influence over the affairs of the organization:

<table>
<thead>
<tr>
<th>Title</th>
<th>Duties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Presidents, CEOs and COOs, and others with the duties described in</td>
<td>Has ultimate responsibility for implementing the decisions of the</td>
</tr>
<tr>
<td>the column to the right</td>
<td>governing body or for supervising the management, administration</td>
</tr>
<tr>
<td></td>
<td>or operation of the organization</td>
</tr>
<tr>
<td>Treasurers and CFOs, and others with duties described in the column</td>
<td>Has ultimate responsibility for managing the finances of the</td>
</tr>
<tr>
<td>to the right</td>
<td>organization</td>
</tr>
</tbody>
</table>

In addition, voting members of the organization’s governing body are treated as disqualified persons. Finally, a person who has a material financial interest in a provider-sponsored organization (as defined in section 1855(e) of the Social Security Act) is a disqualified person with respect to a tax-exempt hospital that participates in the provider-sponsored organization.

Under Treas. Reg. § 53.4958-3(d), the following individuals and entities are not to be treated as disqualified persons:

- An employee who is not described in the previous table (i.e., someone who is not a president, CEO, COO, treasurer or CFO) and receives total economic benefits from the organization (both directly and indirectly) for the year that are less than the following amounts:

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>$120,000</td>
</tr>
<tr>
<td>2014</td>
<td>$115,000</td>
</tr>
<tr>
<td>2013</td>
<td>$115,000</td>
</tr>
<tr>
<td>2012</td>
<td>$115,000</td>
</tr>
<tr>
<td>2011</td>
<td>$110,000</td>
</tr>
<tr>
<td>2010</td>
<td>$110,000</td>
</tr>
</tbody>
</table>

This exemption from status as a disqualified person does not apply to employees of a foundation who have contributed or bequeathed an aggregate amount of more than $5,000 to the foundation during its current taxable year and four preceding taxable years, if the amount is more than 2% of the total contributions and bequests received by the foundation during its current taxable year and four preceding taxable years.

- Section 501(c)(3) tax-exempt organizations (generally, organizations operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals).

- Section 501(c)(4) tax-exempt organizations (generally, organizations operated exclusively for the promotion of social welfare or associations of employees whose membership is limited to the employees of a designated person or persons in a particular municipality and whose net earnings are devoted exclusively to charitable, educational or recreational purposes). This particular exemption from status as a disqualified person applies only in identifying the disqualified persons of section 501(c)(4) organizations.

Treas. Reg. § 53.4958-3(c)(2) provides that the following facts and circumstances tend to show that a person has substantial influence over an organization and, therefore, may be a disqualified person:

- The person founded the organization.

- The person is a substantial contributor to the organization (i.e., has contributed or bequeathed an aggregate amount of more than $5,000 to the organization during its current taxable year and four preceding taxable years, and the amount is more than 2% of the total contributions and bequests received by the organization during its current taxable year and four preceding taxable years).
• The person’s compensation is based primarily on revenues derived from activities of the organization or a particular department or function of the organization that the individual controls.

• The person has or shares authority to control or determine a substantial portion of the organization’s capital expenditures, operating budget or compensation for employees.

• The person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income or expenses of the organization.

• The person owns a controlling interest (as measured by either voting rights or value) in a corporation, partnership or trust that is a disqualified person.

• The person is a nonstock organization controlled, either directly or indirectly, by one or more disqualified persons.

Treas. Reg. § 53.4958-3(e)(3) provides that the following facts and circumstances tend to show that a person does not have substantial influence over an organization, and therefore, may not be treated as a disqualified person:

• The person has taken a bona fide vow of poverty as an employee or agent, or on behalf of, a religious organization.

• The person is a contractor (such as an attorney, accountant, or investment manager or adviser) whose sole relationship to the organization is providing professional advice, without decision-making authority, with respect to transactions from which the contractor will not economically benefit, either directly or indirectly, aside from customary fees received for the professional advice rendered.

• The individual’s direct supervisor is not a disqualified person.

• The person does not participate in any management decisions affecting the organization as a whole or a discrete segment, or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization.

• Any preferential treatment a person receives based on the size of that person’s contribution is also offered to all other donors making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions.
What is the definition of an organization manager?

Summary
An organization manager is any officer, director or trustee, or any individual with similar powers or responsibilities. An individual who serves on your board or a committee of your board that approves compensation for disqualified persons is an organization manager.

Details
The intermediate sanctions tax is imposed on an organization manager if he or she participated in the excess benefit transaction and knew that it was such a transaction. As noted earlier, the tax is equal to 10% of the excess benefit, with a maximum tax of $20,000 for each excess benefit transaction.

The organization managers who participated in the decision-making process that resulted in the excess benefit transaction are jointly and severally liable for the tax. An individual can be both a disqualified person and an organization manager regarding an excess benefit transaction. In that case, the individual is liable for both the tax described previously for disqualified persons and the tax for organization managers.

The organization managers who participated in the decision-making process that resulted in the excess benefit transaction are jointly and severally liable for the tax.

1 Section 4958(a)(2) and Treas. Reg. § 53.4958-1(d)(1).
What can be done to manage the risk of intermediate sanctions?

Summary
The intermediate sanctions regulations allow you to establish a rebuttable presumption that the compensation you pay to your executives is reasonable. If you do so, the burden of proof shifts to the IRS; that is, the IRS has the responsibility to rebut the presumption of reasonableness regarding the compensation if it wishes to do so.

You can establish a rebuttable presumption if your board or a committee of your board takes the following actions:

- It approves the compensation before it is paid
- It relies on external comparable market data in deciding to pay the compensation
- It concurrently documents the basis for its compensation decisions

Grant Thornton can help you establish the rebuttable presumption by gathering and providing a summary of compensation data from appropriate comparable market data sources and comparing the data to the total compensation opportunity you provide to your executives.

We can also render a written opinion as to the reasonableness of the total compensation provided to your executives. Our opinion provides a complete analysis of whether the total compensation opportunity you provide to your executives is reasonable. You can use our analysis to form a solid basis for your compensation decisions and meet the contemporaneous documentation requirement for establishing the rebuttable presumption.

Under the regulations, establishing the rebuttable presumption protects the individuals who participated in the decision-making process from the excise tax, even if the IRS successfully rebuts the presumption. An opinion letter serves the same purpose under the regulations and thus provides an important source of protection for your decision-makers.

Details
Under Treas. Reg. § 53.4958-6(a), you must satisfy three requirements to establish a rebuttable presumption that the compensation for each of your disqualified persons does not constitute an excess benefit transaction. These three requirements are as follows:

1. You must not pay the compensation until it has been approved by an authorized body of the organization composed entirely of individuals who do not have a conflict of interest regarding the compensation arrangement.
2. The authorized body previously described must rely on external, third-party comparable market data in making its decision about the compensation.
3. Records must be concurrently prepared to document the decisions of the authorized body before the later of (a) the next meeting of the authorized body (i.e., the meeting that follows the meeting in which the compensation decision is made), or (b) 60 days after the final actions of the authorized body are taken. The records must be reviewed and approved by the authorized body as reasonable, accurate and complete within a reasonable time period thereafter.

Additional details regarding each of these requirements are discussed in the following section.
Requirement 1 — You must not pay the compensation until it has been approved by an authorized body of your organization composed entirely of individuals who do not have a conflict of interest regarding the compensation arrangement.

Under Treas. Reg. § 53.4958-6(c)(1)(i), an authorized body includes any of the following:

- The tax-exempt organization’s governing body (i.e., board of directors, board of trustees, or equivalent controlling body)
- A committee of the governing body, to the extent the committee is permitted under state law to act on behalf of the governing body
- Other parties authorized by the governing body to act on its behalf, to the extent permitted under state law, by following procedures specified by the governing body in approving compensation arrangements or property transfers

The authorized body must be composed entirely of individuals who do not have a conflict of interest related to the compensation arrangement. Under Treas. Reg. § 53.4958-6(c)(1)(iii), the following individuals are treated as having a conflict of interest:

- A disqualified person participating in or economically benefiting from the total compensation arrangement
- The following family members of the disqualified person referred to previously:
  - Spouse
  - Ancestors (e.g., parents, grandparents and great-grandparents)
  - Children, grandchildren and great-grandchildren
  - Spouses of children, grandchildren and great-grandchildren
  - Brothers and sisters and their spouses
- Employees who are subject to the direction or control of the disqualified person referred to previously
- Individuals who receive compensation or other payments subject to approval by the disqualified person referred to previously
- Any individuals who have a material financial interest that is affected by the compensation arrangement
- An individual whose compensation arrangement has been approved or will be approved by the disqualified person referred to previously
An individual is not treated as a member of the authorized body if he or she meets with the members of the authorized body only to answer questions regarding the total compensation arrangement, but otherwise recuses himself or herself from the meeting and is not present during debate and voting on the compensation arrangement.

**Requirement 2 — The authorized body must rely on external third-party comparable market data in making its decisions about the compensation.**

The intermediate sanctions regulations provide guidance regarding the comparable market data that your authorized body should consider. They begin with a general requirement that “given the knowledge and expertise of its members,” the authorized body must have “information sufficient to determine whether … the compensation arrangement in its entirety is reasonable. …” The regulations then state that relevant information regarding compensation includes, but is not limited to, the following:

- Compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions
- Availability of similar services in the geographic area of the tax-exempt organization
- Current compensation surveys, with sufficient detail, compiled by independent firms
- Actual written offers from similar organizations competing for the services of the disqualified person

Treas. Reg. § 53.4958-6(c)(2)(ii) provides a special rule for organizations with annual gross receipts of less than $1 million. Under the rule, these organizations are treated as having appropriate comparable market data if the organization obtains data from three comparable organizations in the same or similar communities that provide similar services.

**Requirement 3 — Records must be concurrently prepared to document the decisions of the authorized body before the later of (a) the next meeting of the authorized body (i.e., the meeting that follows the meeting in which the compensation decision is made), or (b) 60 days after the final actions of the authorized body are taken. The authorized body must review and approve the records as reasonable, accurate and complete within a reasonable time period thereafter.**

Treas. Reg. § 53.4958-6(c)(i) provides that the records must note all of the following:

- Terms of the transaction that were approved and the date they were approved
- Members of the authorized body who were present during debate on the transaction that was approved and those who voted on it
- Comparability data obtained and relied on by the authorized body and the way the data were obtained
- The basis for any determination that reasonable compensation for a specific arrangement or fair market value in a specific property transfer is higher or lower than the range of comparability data obtained
- Any actions taken related to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest regarding the transaction

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3 Treas. Reg. § 53.4958-6(c)(2)(i).
What are some reasons to undertake an intermediate sanctions study?

There are several reasons for undertaking an intermediate sanctions study, including the following:

- You want to minimize the risk that the intermediate sanctions personal excise taxes will be imposed on your disqualified persons and organization managers.
- You believe you may be paying your disqualified persons at a level that is high in relation to the levels at comparable organizations, or you do not know how your compensation levels compare to those of other organizations.
- You want your Form 990 to demonstrate good governance and best practices regarding your compensation levels through your responses to the following questions:

  - Part VI, line 15, asks questions to indicate whether you established a rebuttable presumption regarding the compensation of your CEO, executive director or top management official, and your other officers or key employees.
  - Part VI, line 25a, specifically asks whether you engaged in an “excess benefit transaction” (i.e., paid unreasonable compensation) related to a disqualified person during the year.
  - Schedule J asks which of six specified approaches you used to establish the compensation for your CEO or executive director. If you undertook an intermediate sanctions analysis and established the rebuttable presumption described previously, you will be able to respond affirmatively that you have used three of the six approaches, which are “independent compensation consultant,” “compensation survey or study” and “approval by the board or compensation committee.” The remaining three are “Form 990 of other organizations,” “written employment contract” and “compensation committee.”

You should be aware that Form 990, Schedule J, provides a detailed breakdown of compensation paid to your “officers, directors, trustees, key employees and highest-compensated employees.” This breakdown includes base compensation, bonus and incentive compensation, retirement and other deferred compensation, nontaxable benefits, and “other reportable compensation.” Thus, the IRS knows the compensation you pay to these individuals and can use the data to launch an audit if it believes the compensation amounts are unreasonable.
What process does Grant Thornton recommend for an intermediate sanctions study?

1. Gather information, including a list of your executives who may be subject to intermediate sanctions (i.e., your disqualified persons); details about their roles, responsibilities and accomplishments; and their total compensation opportunity (e.g., salary, bonus, benefits, perquisites).

2. Gather appropriate comparable market data.

   When Grant Thornton gathers market data, we rely primarily on compensation surveys, although where appropriate we also rely on data from publicly available regulatory filings (e.g., Forms 990 of comparable organizations).

3. Compare the total compensation opportunity provided to disqualified persons at your organization to the appropriate comparable market data and conduct an analysis to determine whether the compensation is reasonable.

   When Grant Thornton compares the compensation provided to a disqualified person with market data to determine whether the compensation is reasonable, we take into account various factors, including appropriate and applicable case law holdings that consider not only comparable market data, but also the nature and scope of each executive’s work and his or her qualifications, and the size and complexity of your organization.

4. Prepare a written report of the study’s findings.

   When Grant Thornton conducts a study, we provide a comprehensive report that demonstrates a very thorough approach and deep understanding of the intermediate sanctions regulations. Our report is designed to withstand stringent IRS scrutiny, and includes the following:
   
   - A detailed listing of all the elements of compensation (“economic benefits”) that you and any related entities provide to your disqualified persons
   - A detailed listing of all our sources of comparable market data
   - A summary of comparable market data for the various elements of total compensation, along with a comparison of those data to the total compensation for your disqualified person
   - Our opinion as to the reasonableness of the total compensation provided to your disqualified persons, and a comprehensive discussion of the reasons for our opinion
   - A detailed description of the regulatory requirements for establishing the rebuttable presumption that the compensation you pay to your disqualified persons is reasonable
What compensation components determine if a disqualified person’s compensation is reasonable?

The intermediate sanctions rules refer to compensation as “economic benefits” and impose the intermediate sanctions taxes on “excess benefits.” An excess benefit exists when an economic benefit provided to a disqualified person by a tax-exempt organization exceeds the value of the consideration received by the tax-exempt organization for providing the economic benefit. Treas. Reg. § 53.4958-4(a) requires that the determination of whether an excess benefit exists take into account all benefits paid to the disqualified person by (1) the tax-exempt organization, (2) any entities that are controlled by the tax-exempt organization and (3) any intermediaries. The entities referred to in items (2) and (3) are defined later in this guide.

An excess benefit exists when an economic benefit provided to a disqualified person by a tax-exempt organization exceeds the value of the consideration received by the tax-exempt organization for providing the economic benefit.

Treas. Reg. § 53.4958-4(b)(ii)(B) identifies the benefits that must be taken into account in determining whether there are any excess benefits. The following table lists all of the economic benefits identified in the regulation.

### Economic benefits identified in the intermediate sanctions regulations

<table>
<thead>
<tr>
<th>Economic benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base salary</td>
</tr>
<tr>
<td>Fees</td>
</tr>
<tr>
<td>Incentive compensation (i.e., short-term and/or long-term)</td>
</tr>
<tr>
<td>Retirement benefits:</td>
</tr>
<tr>
<td>• Qualified retirement plans</td>
</tr>
<tr>
<td>• Supplemental executive retirement plans</td>
</tr>
<tr>
<td>• Other nonqualified deferred compensation plans</td>
</tr>
<tr>
<td>Nonqualified deferred compensation plans that are not of a retirement plan nature</td>
</tr>
<tr>
<td>Health and welfare benefits:</td>
</tr>
<tr>
<td>• Medical benefits</td>
</tr>
<tr>
<td>• Dental benefits</td>
</tr>
<tr>
<td>• Life insurance benefits</td>
</tr>
<tr>
<td>• Short-term disability benefits</td>
</tr>
<tr>
<td>• Long-term disability benefits</td>
</tr>
<tr>
<td>Other broad-based employee benefits</td>
</tr>
<tr>
<td>Executive benefits and perquisites (both taxable and nontaxable), except for non-taxable fringe benefits provided under section 132</td>
</tr>
<tr>
<td>Expense allowances or reimbursements, except for expense reimbursements under an accountable plan that meets the requirements of Treas. Reg. § 1.62-2(c)</td>
</tr>
<tr>
<td>Below-market loans</td>
</tr>
<tr>
<td>Transfers of property</td>
</tr>
<tr>
<td>Payment of liability insurance premiums for any of the following purposes (except for those payments that are excludable from the disqualified person’s income as a de minimis fringe benefit under section 132(a)(4)):</td>
</tr>
<tr>
<td>• Any penalty, tax or expense of correction owed under the intermediate sanctions rules</td>
</tr>
<tr>
<td>• Any expense not reasonably incurred in connection with a civil judicial or civil administrative proceeding arising from the disqualified person’s performance of services</td>
</tr>
<tr>
<td>• Any expense resulting from an act or failure to act with respect to which the disqualified person has acted willfully and without reasonable cause</td>
</tr>
<tr>
<td>Severance payments</td>
</tr>
</tbody>
</table>
Appendix B contains a worksheet for compiling information regarding the economic benefits you provide to your disqualified persons.

Treas. Reg. § 53.4958-4(a)(4) identifies economic benefits that are not taken into account in determining whether there are any excess benefits. The excluded benefits identified in the regulations are as follows:

- Nontaxable fringe benefits under section 132 (i.e., no-additional-cost services, qualified employee discounts, working condition fringe benefits, de minimis fringe benefits, qualified transportation fringe benefits, qualified moving expense reimbursements, qualified retirement planning services, and qualified military base realignment and closure fringe benefits)

- Expense reimbursement payments pursuant to an accountable plan under Treas. Reg. § 1.62-2(c) (generally, an arrangement under which only business expenses for which the individual provides documentation to substantiate the expense may be reimbursed, and under which any payments in excess of the substantiated amounts must be returned by the individual)

- An economic benefit provided to a volunteer for the organization if the benefit is provided to the general public in exchange for a membership fee or contribution of $75 or less per year

- An economic benefit provided to a member of an organization solely on account of the payment of a membership fee, if (1) individuals who are not disqualified persons who pay a membership fee above a specified amount are given the option of receiving substantially the same economic benefit, and (2) the disqualified person and a substantial number of individuals who are not disqualified persons make a payment of at least the specified amount

- An economic benefit provided to a donor solely on account of a contribution for which a deduction is allowable under section 170 (i.e., a charitable contribution), if (1) individuals who are not disqualified persons who make a charitable contribution above a specified amount are given the option of receiving substantially the same economic benefit, and (2) the disqualified person and a substantial number of individuals who are not disqualified persons make a charitable contribution of at least the specified amount

- Economic benefits provided to a charitable beneficiary solely because the person is a member of a charitable class that the tax-exempt organization intends to benefit as part of the accomplishment of its exempt purposes

- Economic benefits provided to or for the use of a governmental unit if the transfer is exclusively for public purposes

- Payments made pursuant to, and in accordance with, a final individual prohibited transaction exemption issued by the Department of Labor under section 408(a) of the Employee Retirement Income Security Act with respect to a plan that is a tax-exempt organization
In addition, “fixed payments” are not subject to the intermediate sanctions excise tax but must be taken into account in determining whether total compensation is reasonable. Thus, the determination of whether a payment is a fixed payment is important only in calculating the amount of the intermediate sanctions excise tax. It is not important in determining the amount of an individual’s total compensation, since fixed payments must be taken into account for that purpose. A fixed payment is either a fixed amount or an amount calculated under a fixed formula that is paid under a contract entered into with a person who was not a disqualified person immediately prior to entering into the contract (such as a new employee of an organization). In order for the payment to be treated as a fixed payment, the contract cannot provide for any discretion as to whether to pay the amount.

If a new contract is later entered into between the organization and the individual, payments under the contract must meet the criteria described earlier in this paragraph at the time the new contract is entered into in order for any payments under the contract to qualify as a fixed payment. Thus, if the individual has become a disqualified person by the time the new contract is entered into, no payments under the contract will qualify as fixed payments. If certain material modifications are made to an existing contract, the contract is treated as a new contract. These modifications include the unilateral extension or renewal of the contract by the individual, and a change to any amount payable under the contract that is more than an incidental change.

Controlled entities

As noted previously, in determining whether there are excess benefits, economic benefits provided to disqualified persons by any entities you control must be taken into account. Treas. Reg. § 53.4958-4(a)(2)(ii)(B) defines “control” as follows:

- In the case of a stock corporation, ownership (by vote or value) of more than 50% of the stock
- In the case of a partnership, ownership of more than 50% of the profits interests or capital interests in the partnership
- In the case of a nonstock organization (i.e., no person holds a proprietary interest), at least 50% of the directors or trustees are either representatives (i.e., trustees, directors, agents or employees) of, or are directly or indirectly controlled by, the tax-exempt organization
- In the case of any other entity, ownership of more than 50% of the beneficial interest in the entity

Intermediaries

As noted previously, in determining whether there are excess benefits, economic benefits provided to disqualified persons by any intermediary must be taken into account. Treas. Reg. § 53.4958-4(a)(2)(i) defines an intermediary as any person (including an individual or a taxable or tax-exempt entity) who participates in a transaction with a disqualified person of the tax-exempt organization. The compensation provided through the intermediary is taken into account only if:

- The tax-exempt organization provides an economic benefit to the intermediary
- There is evidence of an oral or written agreement or understanding that the intermediary will provide economic benefits to or for the use of the disqualified person, or the intermediary provides economic benefits to or for the use of the disqualified person without a significant business purpose or exempt purpose of its own

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How is reasonable compensation for a disqualified person determined under the regulations?

The intermediate sanctions regulations do not provide detailed guidance regarding what constitutes a reasonable amount of compensation. Instead, the regulations provide a general guideline and refer to another section of the Internal Revenue Code under which a significant body of case law has developed regarding whether compensation is reasonable. The general guideline is provided at Treas. Reg. § 53.4958-4(b)(1)(ii), which states that reasonable compensation is the “amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances.” The regulation then states that “Section 162 standards apply in determining reasonableness of compensation, taking into account the aggregate benefits . . . provided to a person and the rate at which any deferred compensation accrues.” Treas. Reg. § 53.4958-4(a)(1) provides that in determining the reasonableness of compensation, taking into account the aggregate benefits provided to a person and the rate at which any deferred compensation accrues. The regulation also provides that the fact that a compensation arrangement is subject to a cap is relevant in determining the reasonableness of compensation, and it also provides that the fact that a state or local legislative or agency body or court has authorized or approved a particular compensation package does not mean compensation is reasonable. This is the full extent of the guidance provided in the intermediate sanctions regulations for determining whether compensation is reasonable.

Given the reference to section 162 noted previously, an analysis of whether compensation is reasonable must take into account the guidance provided under section 162. The section provides that a deduction is allowed for a taxable entity for all the ordinary and necessary expenses paid or incurred in carrying on any trade or business, including “a reasonable allowance for salaries or other compensation for personal services actually rendered.” While the entitlement to a deduction is not relevant for a tax-exempt entity (except when the entity has unrelated business income), the guidance under section 162 regarding a “reasonable allowance for salaries or other compensation” is relevant. Similar to the intermediate sanctions regulations, the regulations under section 162 provide relatively limited guidance regarding reasonable compensation. Specifically, Treas. Reg. § 1.162-7(b)(3) states that “… reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.” This definition of reasonable compensation is identical to the definition under the intermediate sanctions regulations. The only other relevant guidance provided by the regulations under section 162 addresses contingent compensation and bonus payments.

Regarding contingent compensation, the regulations provide that “… if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract, it may prove to be greater than the amount which would ordinarily be paid.”

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5 Section 162(a)(1).
6 Treas. Reg. § 1.162-7(b)(2).
Regarding bonuses, Treas. Reg. § 1.162-9 provides that bonuses to employees will constitute allowable deductions when those payments are made in good faith and as additional compensation for the services actually rendered by employees, provided that when added to salaries, they do not exceed reasonable compensation for the services rendered.

As noted earlier, a significant body of case law has developed under section 162 regarding reasonable compensation. In contrast, there have been no cases that address reasonable compensation under the intermediate sanctions rules. Given that, as well as the limited guidance related to reasonable compensation under both the intermediate sanctions regulations and section 162 regulations, the only authority regarding reasonable compensation that provides detailed guidance is the case law under section 162.

In determining whether compensation is reasonable, the cases under section 162 generally evaluate multiple factors. Specifically, the courts have taken the following factors into account:

- The prevailing rates of compensation for comparable positions at comparable employers
- The nature and scope of the employee’s work
- The employer’s compensation policy for all employees
- The employee’s qualifications
- The compensation paid in prior years
- A comparison of salaries paid with the employer’s gross and net income
- The general economic conditions
- A comparison of salary to distributions to the employer’s shareholders and the employer’s retained earnings
- The size and complexity of the employer’s business
- The employer’s financial position
- The existence of an arm’s-length agreement between the employer and employee
- The existence of an employee guarantee of the employer’s debt
- The general performance and return on equity

The courts do not assign specific weights to each factor. Instead, they evaluate each of the factors and use that analysis to reach an overall conclusion about whether an amount of compensation is reasonable and in setting an amount of compensation they consider reasonable.

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What is an automatic excess benefit?

If you provide an economic benefit to a disqualified person but fail to properly document it as a payment for services, the economic benefit is treated as not being provided for services. This causes the benefit to automatically be treated as unreasonable, which, in turn, causes the benefit to be subject to intermediate sanctions. This type of benefit is commonly referred to as an “automatic excess benefit.”

Treas. Reg. § 53.4958-4(c)(1) provides that to avoid having an automatic excess benefit, you must clearly indicate your intent to provide an economic benefit as compensation for services by providing written substantiation to that effect. The written substantiation requirement may be fulfilled by taking any one of the following actions:

- You report the benefit as compensation on a Form W-2 (for disqualified persons who are employees) or on Form 1099-MISC (for disqualified persons who are not employees).
- The disqualified person reports the benefit as income on his or her income tax return.
- The benefit is documented in a written employment contract executed and approved on or before the date the benefit is provided.
- Documentation is prepared indicating that your authorized body approved the benefit before it was paid.

You are not required to provide any written substantiation for benefits that are not taxable to the disqualified person, such as health benefits. Thus, nontaxable benefits are not subject to the automatic excess benefit rules.
Summary

The personal excise taxes that can be imposed on disqualified persons and organization managers under the intermediate sanctions rules are significant. Fortunately, the risk of intermediate sanctions can be managed by establishing a rebuttable presumption that the compensation paid to disqualified persons is reasonable and obtaining an opinion letter regarding the reasonableness of the compensation.

The rules regarding intermediate sanctions are complex. This guide has addressed the rules by covering the key questions that pertain to intermediate sanctions.
Appendix A—Worksheet to identify disqualified persons

### Identification of disqualified persons based on title

To identify disqualified persons, start by identifying individuals who have certain titles. Under the regulations, individuals with certain titles are treated as disqualified persons unless it can be demonstrated that they do not exercise substantial influence over the affairs of the organization.

Because the regulations look back to the preceding five-year period in identifying disqualified persons, you also need to identify individuals who held the titles listed in the preceding table at any point during the past five years. Thus, in the following table, list all of your current employees who held any of the titles during the past five years. You do not need to list any individuals who are listed in the previous table, because they are already disqualified persons as a result of their current title.

<table>
<thead>
<tr>
<th>Title</th>
<th>Name of individual who currently holds the title</th>
</tr>
</thead>
<tbody>
<tr>
<td>President</td>
<td>For each title, enter the name of the individual who currently has the title. If your organization does not have any current employees who have the title, enter “N/A.”</td>
</tr>
<tr>
<td>CEO</td>
<td></td>
</tr>
<tr>
<td>COO</td>
<td></td>
</tr>
<tr>
<td>CFO</td>
<td></td>
</tr>
<tr>
<td>Treasurer</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Title</th>
<th>Names of individuals who formerly held the title during the past five years</th>
<th>Current title</th>
</tr>
</thead>
<tbody>
<tr>
<td>President</td>
<td>Include all individuals you currently employ who have had the title at any time during the preceding five-year period. There are extra lines in case you have more than one current employee who has had the title within the past five years.</td>
<td>Enter the individual’s current title here</td>
</tr>
<tr>
<td>CEO</td>
<td>For each title, enter either the name of an individual or “N/A” to indicate that your organization does not have any current employees who had the title within the preceding five-year period.</td>
<td></td>
</tr>
<tr>
<td>COO</td>
<td>If you have an employee who has had more than one of the titles within the past five years, list the individual only once in the table; list the person in the row for his or her most recent title.</td>
<td></td>
</tr>
<tr>
<td>CFO</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Treasurer</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Identification of disqualified persons based on duties

The regulations also describe certain duties that cause an individual to be treated as a disqualified person. To identify individuals with those duties, we provide the following table, which is the same as the prior table except that the specific titles are replaced by a description of the duties. Complete the table for current employees who currently have the duties or have had the duties at any point during the preceding five years. You do not need to list any individuals who are listed in the previous tables, because those individuals already have been identified as disqualified persons as a result of being listed in one of those tables.

<table>
<thead>
<tr>
<th>Duties</th>
<th>Names of individuals</th>
<th>Current title</th>
</tr>
</thead>
<tbody>
<tr>
<td>For each description of duties, enter the names of current employees who currently have the duties or who have had the duties at any time during the preceding five-year period. If your organization does not have any such employees who have not already been listed in one of the previous tables, enter “N/A.”</td>
<td></td>
<td>Enter the individual’s current title here</td>
</tr>
<tr>
<td>Has ultimate responsibility for implementing the decisions of the governing body or supervising the management, administration or operation of the organization</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Has ultimate responsibility for managing the finances of the organization</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Voting members of your governing body (list individuals only if you compensate them for their services)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Identification of individuals or entities who are treated as disqualified persons due to their relationship with a disqualified person

By completing the previous tables, you have identified your disqualified persons, except for one final category: individuals and entities you compensate who are related to the disqualified persons you have identified in the previous tables. The following individuals and entities are treated as being related to your disqualified persons:

- Spouse
- Parents, grandparents and great-grandparents
- Children, grandchildren, great-grandchildren and their spouses
- Brothers and sisters and their spouses
- A corporation in which the disqualified person owns more than 35% of the total voting power
- A partnership in which the disqualified person owns more than 35% of the profits interests
- A trust or estate in which the disqualified person owns more than 35% of the beneficial interests

In the following table, first list the individuals and entities who are your disqualified persons. Then list individuals and entities that are related to your disqualified persons. Keep in mind that you need to list the related individuals and entities only if you compensate the individuals and entities.

<table>
<thead>
<tr>
<th>Names of individuals listed in the previous tables</th>
<th>Relationship questions</th>
<th>Names and current titles</th>
</tr>
</thead>
<tbody>
<tr>
<td>In this column, list all of the individuals you have listed in all of the previous tables.</td>
<td>In this column, place a checkmark in the box to indicate whether you currently compensate any of the individuals or entities related to the individual. Check one of the following boxes for the disqualified person listed in the first column:</td>
<td>This column is used only if you check “We do compensate one or more related individuals or entities” in the middle column. Enter the names and current titles of the related individuals and/or entities here.</td>
</tr>
<tr>
<td></td>
<td>We do not compensate any related individuals or entities.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>We do compensate one or more related individuals or entities.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>We do not compensate any related individuals or entities.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>We do compensate one or more related individuals or entities.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>We do not compensate any related individuals or entities.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>We do compensate one or more related individuals or entities.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>We do not compensate any related individuals or entities.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>We do compensate one or more related individuals or entities.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>We do not compensate any related individuals or entities.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>We do compensate one or more related individuals or entities.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>We do not compensate any related individuals or entities.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>We do compensate one or more related individuals or entities.</td>
<td></td>
</tr>
</tbody>
</table>
Appendix B—Worksheet to identify economic benefits provided to disqualified persons

<table>
<thead>
<tr>
<th>Economic benefits identified in the intermediate sanctions regulations</th>
<th>Description and details regarding the benefit provided to disqualified persons (e.g., name of plan or program under which the benefit is to be provided)</th>
<th>Disqualified persons to whom the economic benefit is provided</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base salary</td>
<td>For example, enter the name of the plan or program under which the benefit is to be provided, or in the case of property transfers, identify the specific property to be transferred.</td>
<td>Enter the names of the disqualified persons who will receive each type of benefit.</td>
</tr>
<tr>
<td>Fees</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Incentive compensation (i.e., short-term and/or long-term)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retirement benefits:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Qualified retirement plans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Supplemental executive retirement plans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Other nonqualified deferred compensation plans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonqualified deferred compensation plans that are not of a retirement plan nature</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Health and welfare benefits:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Medical benefits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Dental benefits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Life insurance benefits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Short-term disability benefits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Long-term disability benefits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Other</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other broad-based employee benefits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Executive benefits and perquisites (both taxable and nontaxable), except for nontaxable fringe benefits provided under section 132</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Economic benefits identified in the intermediate sanctions regulations</td>
<td>Description and details regarding the benefit provided to disqualified persons (e.g., name of plan or program under which the benefit is to be provided)</td>
<td>Disqualified persons to whom the economic benefit is provided</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>For example, enter the name of the plan or program under which the benefit is to be provided, or in the case of property transfers, identify the specific property to be transferred.</td>
<td>Enter the names of the disqualified persons who will receive each type of benefit.</td>
<td></td>
</tr>
</tbody>
</table>

**Expense allowances or reimbursements except expense reimbursements under an accountable plan that meets the requirements of Treas. Reg. § 1.62-2(c)**

**Below-market loan**

**Transfers of property**

**Payment of liability insurance premiums for any of the following purposes (except for those payments that are excludable from the disqualified person’s income as a de minimis fringe benefit under section 132(a)(4)):**

- Any penalty, tax or expense of correction owed under the intermediate sanctions rules.
- Any expense not reasonably incurred in connection with a civil judicial or civil administrative proceeding arising from the disqualified person’s performance of services.
- Any expense resulting from an act or failure to act with respect to which the disqualified person has acted willfully and without reasonable cause.

**Severance payments**
About the author

Eddie Adkins is a partner in Grant Thornton’s Washington National Tax Office in Washington, D.C. He has the primary responsibility for tracking new regulatory and legislative developments related to executive compensation and employee benefits. He is a former chair of the AICPA’s employee benefits and compensation technical resource panel, as well as the national employee benefits conference.
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