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# "automatic" excess benefit transactions - fringe benefits and other red flags

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*MSK Client Alert*

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**practice areas**

nonprofit organizations

At a recent nonprofit governance panel discussion, "Identifying and Managing Tax Risks," an IRS official indicated that the IRS is paying significant attention to unreported fringe benefits and other "automatic" excess benefit transactions that result in "intermediate sanctions." As detailed below, automatic excess benefit transactions include:

- the provision of fringe and other benefits for the performance of services without contemporaneous written substantiation;
- expense reimbursements made pursuant to a "nonaccountable plan";
- certain payments by donor-advised funds to donor advisors or substantial contributors; and
- certain payments by supporting organizations to substantial contributors.

You may wish to consider carefully the potential impact of the automatic excess benefit transaction rules on any economic benefit being provided by public charities to their employees, by donor-advised funds to their donors or donor advisors, and by supporting organizations to their donors.

Intermediate sanctions are excise taxes applied to "disqualified persons" of 501(c)(4) and 501(c)(3) organizations (other than private foundations) who receive consideration from the organization in excess of the value of the goods or services that the disqualified person provided. Disqualified persons generally include all those in a position to exercise substantial influence over the tax-exempt organization, including directors, trustees, and executive officers.



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The initial tax on the disqualified person is 25% of the excess benefit, but if the transaction is not "corrected" (i.e., the transaction unwound, the excess compensation paid back, etc.), there is a 200% second-tier tax. Such "excess benefit transactions" can also lead to an excise tax on an organization manager, but the organization itself is not subject to these taxes.

### **Fringe Benefits**

Normally, if a taxable fringe benefit or other perquisite is properly reported as compensation for services, the IRS considers the benefit along with all other compensation to determine whether the total amount paid was reasonable.

However, a benefit is not treated as consideration for the performance of services unless the organization clearly indicated its intent to treat such benefit as compensation. Showing that intent requires written substantiation that is "contemporaneous" with the transfer of the economic benefit at issue.

Written contemporaneous substantiation generally requires the timely reporting of the benefit as compensation on federal tax returns by the tax-exempt organization on Form 990, W-2 or 1099, or by the disqualified person on his or her tax return.

If written contemporaneous substantiation is not provided for a taxable fringe benefit, any services otherwise provided by the disqualified person will not be treated as provided in consideration for the economic benefit. In that case, the benefit is seen as being given away to the disqualified person, and IRS Agents are instructed to treat the entire value of the benefit as an automatic excess benefit transaction subject to intermediate sanctions.

For example, assume that a 501(c)(3) paid for its president's trip to Italy (on official business) and also paid \$5,000 for the president's spouse to go along (not on official business). The 501(c)(3) intended for the spouse's travel to be a compensatory bonus paid to the president, but did not withhold the additional income or employment taxes, nor report the additional compensation on its Form 990, the president's W-2, or otherwise. The written contemporaneous substantiation requirements were not met, and so the \$5,000 payment is an automatic excess benefit transaction, whether or not the president's total compensation was still reasonable. The president may be liable for (i) income and employment taxes on the \$5,000 in compensation, (ii) 25% and 200% "intermediate sanctions" excise taxes, (iii) a penalty of 100% of the amount of the excise tax if it was a willful and flagrant violation, and (iv) a penalty for failure to pay the applicable excise taxes. The 501(c)(3) may be liable for the applicable income and employment taxes.

### **Expense Reimbursements Paid Pursuant to Nonaccountable Plans**

The reimbursement of an expense incurred by a disqualified person and paid by a tax-exempt organization under a reimbursement arrangement that fails to qualify as an "accountable plan" may be characterized as an automatic excess benefit transaction.

To be an "accountable plan," a tax-exempt organization's reimbursement or allowance arrangement must require (i) that the expenses have a business connection, (ii) adequate accounting for expenses within a reasonable



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period of time (including documentary evidence of the business expenses, such as receipts), and (iii) the return of any excess reimbursement within a reasonable period of time. A "nonaccountable plan" is a reimbursement or expense allowance arrangement that does not meet one or more of these three rules.

If a poorly managed reimbursement plan turns out to be a nonaccountable plan, it is unlikely that the tax-exempt organization or disqualified person will have satisfied the written contemporaneous substantiation requirements described above. In that case, IRS Agents are instructed to treat the full amount of such reimbursements as automatic excess benefit transactions subject to intermediate sanctions.

As a result, the disqualified person may be liable for (i) income and employment taxes on the amount of the reimbursement, (ii) 25% and the 200% "intermediate sanctions" excise taxes, (iii) a penalty of 100% of the amount of the excise tax if it was a willful and flagrant violation, and (iv) a penalty for failure to pay the applicable excise taxes. The organization may be liable for the applicable income and employment taxes.

### **Payments by Donor Advised Funds to a Substantial Contributor or a Donor Advisor**

Any grant, loan, compensation, or "other similar payment" from a donor-advised fund to a "substantial contributor" (as described below), donor advisor, or a person related to such substantial contributor or donor advisor generally is an automatic excess benefit transaction. Thus, the entire amount paid is treated as an excess benefit subject to intermediate sanctions.

"Other similar payments" include payments in the nature of a grant, loan, or payment of compensation, such as expense reimbursements. They do not include payments pursuant to a bona fide sale or lease of property, for example, which remain subject to intermediate sanctions if an "excess benefit" was provided (i.e., the amount paid by the donor-advised fund was more than reasonable).

### **Payments by a Supporting Organization to a Substantial Contributor**

If a supporting organization makes a grant, loan, payment of compensation, or "other similar payment" (as described above) to a "substantial contributor" (or person related to the substantial contributor) of the supporting organization, the entire payment is treated an excess benefit subject to intermediate sanctions.

For this purpose, a "substantial contributor" generally includes any person who contributed or bequeathed an aggregate amount of more than \$5,000 to the organization, if such amount is more than 2% of the total contributions and bequests received by the organization before the close of the applicable tax year of the organization. In the case of a trust, "substantial contributor" also means the creator of the trust.

As indicated above, the IRS is on the lookout, so you may wish to consider carefully the potential impact of the automatic excess benefit transaction rules on any benefits being provided (i) by 501(c)(3) public charities and 501(c)(4) organizations to their employees, (ii) by donor-advised funds to their substantial contributors or donor advisors, and (iii) by supporting organizations to their substantial contributors.



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If you have any questions about this Alert, please contact the author or any member of the MSK Charitable Sector Practice Group.