Rebuttable Presumption Procedure is Key to Easy Intermediate Sanctions Compliance

REBUTTABLE PRESUMPTION PROCEDURE IS KEY TO EASY INTERMEDIATE SANCTIONS COMPLIANCE

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The Treasury Department recently issued extensive regulations implementing IRC 4958.[2] This statute imposes intermediate sanction taxes on top officials within certain tax-exempt organizations who receive excess compensation from their organization.[3] The Regulations are somewhat long and complex. However, the Regulations contain a relatively simple procedure for insuring that all top officials are in full compliance, and thus not liable for the taxes. This article explains how to determine which officials the Regulations cover, and suggests a relatively simple process for ensuring that these officials are in full compliance.

The procedure is called creating a "rebuttable presumption of reasonableness.[4]" The procedure is not required, but is potentially advantageous to all persons covered by the new Regulations. The procedure for ensuring compliance is somewhat similar to obtaining data and filling out the annual Form 990 information return. As in preparing the Form 990, the procedure involves many steps, and accurate documentation. But once the process is established, following it becomes a rather routine task.

Please note that it is not necessary to use the process I am suggesting; but it is one method by which the organization may ensure that it satisfies any inquiry by the IRS into the reasonableness of the compensation of it high-paid influential persons. Moreover, the process may be unnecessary in many, or even most, small organizations.

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[1] The views in this article are my views, and do not necessarily reflect the official position of the Treasury Department or the Internal Revenue Service. For a more complete explanation of the Section 4958 regulations, including the rebuttable presumption, see Steven T. Miller, "Easier Compliance is Goal of New Intermediate Sanction Regulations," 2001 *Tax Notes Today* 14-148 (Jan. 22, 2001).

[2] These Regulations are set forth in 26 CFR 53.4958-1T *et seq*.

[3] In addition to excess **compensation,** IRC 4958 applies to certain non-fair-market-value **property** transactions favoring such persons at the expense of the exempt organization. The statute also imposes taxes on organization managers who do not benefit from the compensation arrangement or property transaction but nonetheless knowingly and willfully participated. . This article is limited to compensation transactions, as they generally continue from year to year and are the most numerous.

[4] The rebuttable presumption can also be obtained for property transfers to, or from, disqualified persons. Your tax adviser can help you obtain a rebuttable presumption for property transfers covered by the Regulations.

For example, if your organization is paying below-market salaries, this process may be superfluous.

COVERED INDIVIDUALS

IRC 4958 and the Regulations cover "disqualified persons." These persons are generally the officers and directors of the organization (and possibly a few other influential persons in the organization) holding the positions during the prior five-year period ending on the date of the compensation transaction. The first time you go through the procedure, you may have to ask advice of a lawyer or accountant to determine exactly who in your organization are classified as disqualified persons. IRS Customer Service staff are also available by telephone at 1-877-529-5500 and can answer questions involving simple fact situations. Generally, once the organization has determined its list of disqualified persons, the list need only be reconsidered when an individual changes jobs (or their job description changes) or a new influential person is hired. Of course, as the five-year period elapses, persons can be removed from the list.

PROCEDURE

For each disqualified person, there is a simple procedure to obtain the rebuttable presumption respecting compensation arrangements.[5]

WHO MUST MAKE THE DECISION:

The board of directors or trustees, or other compensation-setting body, must obtain compensation comparability data for the position. If an organization uses a compensation-setting body, it must be composed of members of the board of directors or trustees or other governing body (or a select committee of that body), unless state law authorizes other persons to perform that function. The members who participate may not have any personal interest in the compensation arrangement. For example, neither the employee whose compensation is at issue, nor the employee's subordinate, may participate in the decision about the compensation. Because each member of the compensation-setting body must be disinterested, the body may be differently constituted depending on the employee whose compensation is under review.

WHAT DATA MUST BE USED:

The comparability data may be based on industry surveys, documented compensation of persons holding similar positions in similar organizations, expert compensation studies, or other comparable data. Organizations with gross receipts of

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[5] A disqualified person's compensation may change yearly. If this happens, and you want to establish a rebuttable presumption for those years, you will need to follow the procedure yearly. For disqualified persons with fixed multi-year contracts, the procedure will only have to be conducted again when there is a material change or a new contract. Annual cost-of-living increases, based on government cost-of–living figures, would not necessitate a new procedure.

less than $1 million per year only need compensation data for three similar positions in similar communities. For other organizations, the Regulations do not specify the number of comparables or comparability sources required. Data may be obtained by any means, including documented phone calls.

The decision-making body must approve the compensation, without discussion or voting participation by the person whose compensation is being approved or any other member with a conflict of interest. However, that person may answer questions that will help the decision-making body in its later deliberations.

HOW TO DOCUMENT THE DECISION:

The decision-making body must document the basis for its determination concurrently with the approval. The documentation must contain:

(1) the terms of the approved transaction and the date approved;
(2) the members of the decision-making body who were present during debate on the transaction that was approved and those who voted on it;
(3) the comparability data that was relied on by the decision-making body and how the data was obtained; and
(4) any actions by a member of the decision-making body having a conflict of interest.

WHEN TO DOCUMENT THE DECISION:

The documentation must be **prepared** before the **later** of the next meeting of the decision-making body, or 60 days after the final actions of the body. In addition, the decision-making body must approve the documentation within a reasonable time after preparation.

BENEFITS FOR FOLLOWING THIS PROCEDURE

If these procedures are followed with respect to each disqualified person, then the organization is entitled to a rebuttable presumption that the compensation provided is reasonable. The Service would not ordinarily challenge apparently appropriate and relevant compensation data with its own data. The Service may only rebut the presumption if it develops sufficient contrary evidence to rebut the probative value of the organization's supporting compensation data.

If your organization is careful in timely preparing the required documents, you will ensure that all four requirements of the rebuttable presumption safe harbor will be satisfied. A simple checklist, like that on this page, will be helpful (though not necessary) for insuring that your organization gets the benefit of this presumption. See box on this page.

REBUTTABLE PRESUMPTION CHECKLIST

1. Name of disqualified person: _____

2. Position under consideration: _____

3. Duration of contract (1 yr., 3 yr., etc): _____

4. Proposed Compensation:

   Salary: _____
   Bonus: _____
   Deferred compensation: _____
   Fringe benefits (list, excluding Sec. 132 fringes):
   _____ _____ _____ _____
   _____ _____ _____ _____

   Liability insurance premiums: _____
   Foregone interest on loans: _____
   Other: _____

5. Description of types of comparability data relied upon (e.g., association survey, phone inquiries, etc.):

   a)_____

   b)_____

   c)_____

   d)_____

6. Sources and amounts of comparability data:

   Salaries _____ _____ _____

   Bonuses: _____ _____ _____

   Deferred compensation: _____ _____ _____

   Fringe benefits (list, excluding Sec. 132 fringes):

   _____ _____ _____ _____
   _____ _____ _____ _____
   _____ _____ _____ _____
   _____ _____ _____ _____

   Liability insurance premiums: _____ _____ _____

   Foregone interest on loans: _____ _____ _____

   Others: _____ _____ _____

7. Office or file where comparability data kept: _____

8. Total proposed compensation: _____

9. Maximum total compensation per comparability data: _____

10. Compensation package approved by authorized body:

    Salary: _____
    Bonus: _____
    Fringe benefits (list, excluding Sec. 132 fringes):
    _____ _____ _____

    Deferred compensation: _____
    Liability insurance premiums: _____
    Foregone interest on loans: _____
    Other: _____

11. Date compensation approved by authorized body: _____

12. Members of the authorized body present (indicate with X if voted in favor):

_____
_____
_____
_____
_____
_____
_____

13. Comparability data relied upon by approving body and how data was obtained:

_____
_____
_____

14. Names of and actions (if any) by members of authorized body having conflict of interest:

_____
_____
_____

15. Date of preparation of this documentation (must be prepared by the later of next meeting of authorized body, or 60 days after authorized body approved compensation): _____

16. Date of approval of this documentation by Board (must be within reasonable time after preparation of documentation above):

_____