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BLOG POST

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What are “Intermediate Sanctions,” and how can your organization avoid them?

Nonprofit organizations increasingly find themselves in competition for talent. This competition can come from other similar nonprofits or with the private sector. That competition often plays out in rising executive compensation levels. Paying too much compensation could blow up the organization’s tax-exempt status, since the IRS might treat it as “private inurement” — that is, using tax-exempt assets for the private benefit of one individual. But there is some good news for entities that are tax-exempt under IRC Sections 501(c)(3) and (4). Instead of losing their entire tax-exempt status, they may only face the IRS’s “intermediate sanctions” rules. These sanctions are essentially financial penalties imposed on "disqualified persons" who receive excess benefits from their involvement with a 501(c)(3) or (4) nonprofit organization. A disqualified person could be an executive director, chief executive officer, chief financial officer, or other individuals in positions of substantial influence over the organization.

The cornerstone of compliance lies in the "rebuttable presumption of reasonableness." This legal safeguard allows 501(c)(3) and (4) nonprofits to demonstrate that the compensation they provide to disqualified individuals is reasonable.

While there are many nuances to achieving compliance, at a high level, it involves three critical steps:

1. **Ensuring Compensation Decisions Are Made by an Authorized Body:** The compensation arrangement must be approved by an independent body or committee composed of individuals who do not have a conflict of interest concerning the compensation arrangement.
2. **Relying on Comparable Data:** The compensation must be benchmarked against pay data from similarly sized organizations in the same sector and region (or an offer letter). This comparison ensures that the pay is in line with what is being offered for similar roles under similar circumstances.
3. **Documenting the Decision-Making Process:** The rationale behind the compensation decision, including the data used for comparison and the deliberation process, must be documented contemporaneously. This documentation serves as evidence that the organization acted responsibly and with due diligence.

BDO’s survey of more than 500 nonprofit organizations highlights the importance of accessing quality, up-to-date data to make informed compensation decisions. With over 500 nonprofit organizations participating, the survey provides a wealth of information on executive compensation practices, including salaries, bonuses, and deferred compensation. This data, and sources like it, are invaluable for nonprofits aiming to establish compensation that is both competitive and compliant with IRS regulations.

Navigating the complexities of intermediate sanctions requires a proactive approach centered on informed decision-making, transparency, and thorough documentation. By adhering to these principles, 501(c)(3) and (4) nonprofit organizations can ensure they remain in compliance while fulfilling their mission and attracting the talent necessary to thrive. Other tax-exempt organizations (who are tax-exempt under different sections like 501(c)(6), for example) can follow the intermediate sanctions rebuttable presumption of reasonableness as best practices, even though, technically, they are not entitled to the intermediate sanction relief. Those organizations remain at risk for possibly losing their entire tax-exempt status if they pay excessive compensation. So, they should be proactive by reviewing executive compensation under the intermediate sanction rules as good governance and documenting their review process, in case their compensation practices are ever challenged by the IRS.

Learn more about BDO's survey findings here and explore BDO's services for employers.