

## Work Group Recommendations to the Panel on the Nonprofit Sector Posted for Public Comment January 27, 2005

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### #13: Standards for Imposition of Penalties on Organization Managers

#### I. Governance and Fiduciary Responsibility Work Group Recommendations

##### A. Statement of Problem

Sections 4941, 4944, 4945 and 4958 of the Internal Revenue Code impose excise taxes on an organization manager if he or she knowingly participates in certain actions, which are defined respectively in those Code sections, unless his or her participation was not willful and was due to reasonable cause.<sup>1</sup> Legislative language has been drafted and circulated that would change the threshold for imposition of these penalties from a “knowing” to a “should have known” standard and striking the phrase “unless such participation is not willful and is due to reasonable cause.”

##### B. Recommendations

The current standard for imposition of penalties on managers of organizations—knowing and willful participation not due to reasonable cause—should not be changed. In addition, the current penalty provisions should be effectively enforced, and, if stiffer sanctions on managers knowingly and willfully violating the law without reasonable cause are necessary, the penalties should be increased.

##### C. Rationale

Penalties on bad actors should be stiff and imposed without hesitation. Changing the standard, however, to a “should have known” standard will introduce a new degree of uncertainty into the affairs of board members, will likely result in costly legal consultation fees and will undoubtedly have a detrimental impact on the ability of organizations to recruit knowledgeable individuals to serve on boards. The Work Group is unaware of any data showing that the IRS is having difficulty imposing excise taxes on organization managers under the current standard. There is no clear indication that

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<sup>1</sup> Three of these provisions restrict activities of private foundations: section 4941 concerns self-dealing transactions; section 4944 concerns jeopardizing investments, and section 4945 concerns taxable expenditures. Section 4958 prohibits public charities from engaging in excess benefit transactions. An organization manager is statutorily defined for each of the provisions and is generally someone who is, or who has powers or responsibilities similar to, an officer, director or trustee of the organization or, in the case of a private foundation, any employee who has responsibility or authority over the decision in question.

Note: These recommendations have not yet been reviewed by the Panel on the Nonprofit Sector. They will be part of the deliberations by the Panel as it prepares its interim report.

changing the standard from the current “knowing and willful” to the “should have known” will have any positive effect on preventing wrongful actions from occurring. Compliance can be improved by investing in additional educational and technical assistance to train organization managers and provide them with appropriate legal advice.

#### **D. Other Considerations**

No consensus was reached on whether insurance proceeds and indemnification agreements should be available to cover the excise taxes imposed on managers. Some Work Group members expressed the opinion that if a manager knowingly and willfully approves a prohibited transaction, he or she should not have insurance proceeds or indemnification available. Other group members were concerned that a lack of insurance or indemnification coverage would make it more difficult to retain and recruit board members.

## **II. Expert Advisory Group Comments**

The Expert Advisory Group recommends that the legislation described above in the Statement of the Problem should be enacted and that a parallel amendment should be made to section 4958(a)(2). To avoid unduly harsh results, the EAG also recommends that section 4962 should be amended to empower the IRS to abate the first tier penalty tax on foundation managers under section 4941. Finally, the EAG recommends that the Panel, as part of its work in Phase II, develop recommendations for more appropriate standards for abatement. Some factors to consider would be whether the organization manager received an excess benefit or if the organization’s assets were protected for charitable use.

With respect to Other Considerations, the Expert Advisory Group recommends that indemnification should be available for self-dealing transactions under section 4941 only if such indemnification would be permitted under applicable state law.