

**USING THE “REBUTTABLE PRESUMPTION OF REASONABLENESS”
PROCEDURE TO COMPLY WITH THE FINAL REGULATIONS
ON “INTERMEDIATE SANCTIONS”**

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The Internal Revenue Service (the “IRS”) recently issued final regulations (the “Final Regulations”) on “intermediate sanctions” under section 4958 of the Internal Revenue Code of 1986, as amended (the “Code”). The Final Regulations apply to organizations that are exempt from federal income taxation under Code section 501(c)(3) and that have been classified by the IRS as “public charities”, as well as any Code section 501(c)(4) organization (i.e., a civic organization, a social welfare organization, or a local association of employees).¹ The Final Regulations do not apply to exempt organizations that are classified by the IRS as private foundations.

Although rather lengthy and often complicated, the Final Regulations provide persons who are in a position to exercise substantial influence over a charity, including directors, officers and key employees, with a simple and straightforward procedure to follow to avoid being subject to the “intermediate sanctions”. This procedure is referred to as establishing a “rebuttable presumption of reasonableness”, and is explained in greater detail in this memorandum.

WHAT ARE “INTERMEDIATE SANCTIONS”?

Penalty taxes, or “intermediate sanctions”, are due if a charity pays an “excess benefit” to any “insider”. The penalty taxes are payable by the insider, not the charity. An insider is a person or entity in a position to exercise substantial influence over the charity. An excess benefit includes any economic benefit received by an insider that exceeds the value of what the charity received in return. The two most common excess benefit transactions are (1) the payment of excessive compensation or employee benefits, and (2) sales of property to insiders for less than the property’s fair market value. Compensation received by an insider from a charity will not be an “excess benefit” if the amount of the compensation is “reasonable”. Reasonable compensation generally means the amount that would ordinarily be paid for similar services by a similar organization.

¹ For the sake of simplicity, any organization subject to the Final Regulations will be referred to in this memorandum as a “charity”.

**WHO MAY BE SUBJECT TO
INTERMEDIATE SANCTIONS?**

As discussed above, the intermediate sanctions may be imposed on any “insider”, that is, a person who is in a position to exercise substantial influence over a charity during the five-years preceding the date of the transaction in question. In general, whether a person is in a position to exercise substantial influence over a charity is determined by the person’s actual powers and responsibilities and not merely by the person’s title.

The Final Regulations provide three categories of persons who are automatically deemed to have substantial influence over a charity. The first category includes (1) voting members of the charity’s governing body; (2) the president, chief executive officer or chief operating officer of the charity; (3) the treasurer or chief financial officer of the charity; and (4) anyone holding any of the powers or responsibilities of the persons described in (1), (2) or (3) regardless of title. The second category of persons includes family members (e.g., spouses, brother*s or sisters, spouses of brothers or sisters, ancestors, descendants, and spouses of descendants) of persons described in the first category. The third category of persons includes any entity in which 35% or more of the combined voting power (in the case of a corporation), profits interest (in the case of a partnership), or beneficial interest (in the case of a trust) is owned by persons described in the first and second categories above.

In addition, the Final Regulations provide examples of persons who may be, but are not automatically deemed to be, in a position to exercise substantial influence over a charity. These persons include (1) founders of the charity; (2) substantial contributors to the charity; (3) persons who are compensated on the basis of revenues derived from the charity’s activities under their control; (4) persons who have the authority to control or determine a significant portion of the charity’s capital expenditures, operating budget or employee compensation; or (5) persons who manage a discrete segment of the organization that represents a substantial portion of the activities of the organization.

In addition to the penalty tax imposed on an insider who enters into an excess benefit transaction with a charity, penalty taxes may also be imposed on any officer or director who approves the granting of an excess benefit to an insider knowing it to be excessive.

**WHAT IS THE REBUTTABLE PRESUMPTION OF
REASONABLENESS?**

The governing board of a charity can use the “rebuttable presumption of reasonableness” to shift to the IRS the burden of proving that a particular transaction (such as the payment of compensation or the sale of an asset) with an insider was excessive and, therefore, subject to intermediate sanctions. If a charity fails to establish the rebuttable presumption of reasonableness, this failure does not create an inference that a particular

transaction has resulted in a violation of the rules. Instead, this failure means that the charity must prove to the IRS, if questioned, that the transaction was reasonable.

In addition, if the board uses the “rebuttable presumption of reasonableness”, the officers and directors who approve of the transaction will not be subject to intermediate sanctions. Consequently, the rebuttable presumption is helpful to both the insider and the board and officers.

HOW IS THE REBUTTABLE PRESUMPTION OF REASONABLENESS ESTABLISHED?

In order to establish the “rebuttable presumption of reasonableness”, the charity must follow the following three-step procedure:

1) ***Advance Approval by Board.*** The transaction must be approved by the charity’s governing board,² and no member of the board may have a conflict of interest with respect to the transaction. If a member of the board does have a conflict of interest with respect to the transaction, that member may meet with the other members of the board only to answer questions and then must leave the room and cannot participate in the debate or vote on the transaction.

2) ***Reliance on Appropriate Data.*** The board must obtain and rely upon appropriate data as to comparable transactions prior to approving the transaction.

Examples of appropriate data with respect to the payment of compensation to an insider include (1) the amount of compensation paid by similarly-situated organizations, both taxable and tax-exempt, for positions with comparable functions and tasks; (2) information on whether similar services are available in the geographic area where the charity is located; (3) current compensation surveys compiled by independent firms; and (4) actual written offers from similar institutions competing for the services of the insider. A charity with annual gross receipts (including contributions) of less than \$1 million will be considered to have obtained appropriate data as to compensation if the charity gathers compensation data from three comparable organizations in the same or similar community for similar services. Boards of organizations with higher receipts will be expected to gather more data.

For property transactions, examples of appropriate data include (1) independent appraisals of the value of the property involved in the transaction; and (2) offers received with respect to the property as part of an open and competitive bidding process.

² If state law permits, these actions may be taken by a committee of the board. Note that the New York Not-for-Profit Corporation Law requires that the board approve the compensation of directors and officers, unless otherwise provided in the charity’s certificate of incorporation or bylaws.

3) *Adequate and Contemporaneous Documentation of the Board's Decision.* The board of the charity must adequately document the basis for its determination with respect to a particular transaction, concurrently with making the determination.

For a determination to be documented adequately, written or electronic records must be prepared before the later of (1) the next meeting of the board or (2) 60 days after the final determination has been made. These written or electronic records must contain the following information: (1) a description of the terms of the transaction that was approved and the date it was approved; (2) a list of the members of the board who were present during the debate on the transaction that was approved and those who voted in the decision; (3) a description of the comparability or other data obtained and relied upon by the board and how that data was obtained; and (4) a record of the actions of any members of the board having a conflict of interest with respect to the transaction. In addition, these written or electronic records must be approved by the governing body that authorized the transaction "as reasonable, accurate and complete within a reasonable time period thereafter".

**EXAMPLES OF ESTABLISHING
THE REBUTTABLE PRESUMPTION**

Example One – Small Charitable Organization

A local repertory theater ("Theater") has been classified as a public charity and is therefore subject to the intermediate sanctions rules. Theater has had annual gross receipts ranging from \$400,000 to \$800,000 over its past three taxable years. Theater needs to determine the next year's compensation for Theater's artistic director ("Artistic Director"). Artistic Director has substantial influence over Theater, and therefore compensation paid to Artistic Director is subject to the intermediate sanctions rules.

In determining Artistic Director's compensation, the board of directors of Theater relies on data compiled from a telephone survey of three other unrelated performing arts organizations of similar size in similar communities to the one in which Theater is located. A member of the board drafts a brief written summary of the annual compensation information obtained from this informal survey. The annual compensation information obtained in the telephone survey is appropriate data as to comparability and therefore the second requirement of the rebuttable presumption of reasonableness is established.

The board, which does not include Artistic Director or any other member with a conflict of interest with respect to the transaction, approves the payment of compensation, thus meeting the first requirement of the rebuttable presumption of reasonableness. At its next board meeting the board approves the minutes of the prior meeting. The minutes describe the terms of the compensation paid to Artistic Director, the date the compensation was approved, a list of the board members who were present at the meeting and who approved the payment of

compensation and the written summary of comparable compensation information. Therefore, the third requirement of the rebuttable presumption is met.

Thus, the burden is shifted to the IRS to prove that the compensation payment to Artistic Director is excessive. In addition, because the payment was approved using the three-step procedure, even if the payment is ultimately determined to be excessive, the board members who approved the payment will not be subject to penalty taxes.

Example Two – University

A university (“University”) has been classified as a public charity and is therefore subject to the intermediate sanctions rules. University is negotiating a new contract with its president (“President”), because President’s existing contract will expire at the end of the year. President has substantial influence over University, and therefore compensation paid to President is subject to the intermediate sanctions rules.

In setting President’s compensation at \$500X per annum, the board of University relies solely on a national survey of compensation for university presidents that indicates university presidents receive annual compensation in the range of \$100X to \$700X; this survey does not divide its data by any criteria, such as the number of students served by the university, or annual revenues, academic ranking or geographic location of the university. Although many members of the board have significant business experience, none has any particular expertise in higher education compensation matters. Given the failure of the survey to provide information specific to universities comparable to University, and because no other information was presented, the board’s decision with respect to President’s compensation was not based upon appropriate data as to comparability and therefore President and the board cannot rely on the rebuttable presumption of reasonableness.

However, if University’s national compensation survey divided the data regarding compensation for university presidents into categories based on various university-specific factors, including the size of the institution (in terms of number of students served and amount of annual revenues) and geographic area, and the board set President’s compensation at \$300X, based on survey data showing that university presidents at institutions comparable to and in the same geographic area as University, receive annual compensation in the range of \$250X to \$325X, then the data relied upon by the board would constitute appropriate data as to comparability and the second requirement of the rebuttable presumption of reasonableness would be established.

The board, which does not include President or any other member with a conflict of interest with respect to the transaction, approves the payment of compensation, thus meeting the first requirement. At its next board meeting the board approves the minutes of the prior meeting. The minutes describe the terms of the compensation paid to President, the date the compensation was approved, a list of the board members who were present at the meeting and

who approved the payment of compensation and the data relied upon by the board. Therefore, the third requirement of the rebuttable presumption is met.

Thus, the burden is shifted to the IRS to prove that the compensation payment to President is excessive. In addition, because the payment was approved pursuant to the three-step procedure, even if the payment is ultimately determined to be excessive, the board members who approved the payment will not be subject to penalty taxes.

**THE REBUTTABLE
PRESUMPTION CHECKLIST**

The Internal Revenue Service has published a “Rebuttable Presumption Checklist”, a copy of which is attached to this memorandum. The checklist is intended to assist boards in creating documentation sufficient to establish the rebuttable presumption of reasonableness described above.

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If you have any questions about specific situations or would like further information or assistance regarding any provision of the Final Regulations or the establishment of the “Rebuttable Presumption of Reasonableness”, please contact Victoria B. Bjorklund (212-455-2875 or v_bjorklund@stblaw.com), David A. Shevlin (212-455-3682 or d_shevlin@stblaw.com), Jennifer I. Goldberg (212-455-2287 or j_goldberg@stblaw.com), Jennifer L. Franklin (212-455-3597 or j_franklin@stblaw.com) or any other member of our Exempt Organizations Department.

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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):
