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# PROPOSED REGULATIONS ON "INTERMEDIATE SANCTIONS" APPLICABLE TO PERSONS ASSOCIATED WITH OR EMPLOYED BY PUBLIC CHARITIES AND CERTAIN OTHER TAX-EXEMPT ORGANIZATIONS

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On July 30, 1998, the Internal Revenue Service (the "IRS") published proposed regulations explaining when penalty taxes can be imposed on certain insiders (known as "disqualified persons") in the event of "excess benefit transactions" with a public charity or social welfare organization. The proposed regulations are of interest to anyone who serves as a director, officer, or highly compensated employee of a public charity or social welfare organization because they detail what procedures boards of directors may follow to benefit from a presumption of reasonableness in reviewing compensation packages of, sales of property to, or other transactions with insiders.

The proposed regulations were issued two years to the day after the law they interpret was signed. That law created section 4958 of the Internal Revenue Code,[1] the so-called "intermediate sanctions law." The penalties are called "intermediate sanctions" because they are "intermediate" between the IRS doing nothing and the IRS using what was previously its only sanction, *i.e.*, revoking an organization's tax exemption. Section 4958 and the proposed regulations are modelled on the private foundation self-dealing penalties that have been in effect since 1969 and that are considered by the IRS and Congress effectively to have curbed abuses in the private foundation sector. The enactment of the intermediate sanctions law and issuance of these proposed regulations are the most significant developments affecting public charities in the last 25 years.

The proposed regulations do not change the substantive standards for tax exemption, nor do they prevent the IRS from revoking an organization's tax exemption. However, the preamble to the proposed regulations states that, in practice, the penalty taxes will be the sole sanction imposed where the excess benefit does not rise to a level where it calls into question whether the organization functions as a charitable or other tax-exempt organization.

The proposed regulations are divided into seven sections in which the IRS sets out critical definitions, including "applicable exempt organizations" to which the law and regulations apply, who is a "disqualified person," and what is an "excess benefit transaction." The summary in this memorandum follows those divisions.

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1 All section citations are to the Internal Revenue Code of 1986, as amended.

The proposed regulations are 84 pages long and contain 23 examples. Therefore, the explanation which follows is necessarily a summary of the more significant definitions, interpretations, and examples. Comments on the proposed regulations are requested from the public on or before November 2, 1998. The proposed regulations may be relied on by individuals and organizations immediately. In the event that the final regulations contain more restrictive provisions, those provisions will apply only prospectively.

## TAXES IMPOSED: 25% INITIAL PENALTY ON DISQUALIFIED PERSON, 200% IF NOT CORRECTED, 10% ON MANAGERS WHO KNOWINGLY PARTICIPATE

Taxes on Disqualified Persons. An initial penalty tax equal to 25 percent of the excess benefit amount is payable by the disqualified person(s) involved. In general, the excess benefit is the amount by which the value of the economic benefit received by the disqualified person(s) from the applicable tax-exempt organization exceeds the value of the consideration (including performance of services) the disqualified person(s) provided in return.[2] If the excess benefit is not corrected, a tax of 200 percent of the excess benefit amount is payable by the disqualified person. Both penalty taxes are imposed on the disqualified person, not the organization. The disqualified person can "correct" the excess benefit by repaying an amount of money equal to the excess benefit, *plus* any additional amount to compensate the organization for the loss of the use of the money or property or, in certain circumstances, by returning the property to the organization and taking additional steps necessary to make the organization whole. In order to avoid the assessment of the additional 200 percent tax, correction must be completed prior to the earlier of the date of mailing of a notice of deficiency with respect to the penalty tax due or the date on which this tax is assessed. If more than one disqualified person is involved, all are jointly and severally liable for the initial and any additional taxes. The definition of a "disqualified person" is discussed below at page 3.

Taxes on Organization Managers. A tax of 10 percent of the excess benefit amount is imposed on each organization manager who knowingly participates in an excess benefit transaction, unless participation is not willful and is due to reasonable cause. This tax is subject to a cap of $10,000 per transaction. If more than one organization manager is liable for the tax, all are jointly and severally liable. If the organization manager also receives an excess benefit, the manager may be liable for both the 10 percent tax and the 25 percent tax.

An organization manager "knowingly" participates if the manager (i) has actual knowledge of facts that show that the transaction provides an excess benefit, (ii) is aware that the transaction may violate federal tax law, and (iii) negligently fails to make reasonable

[2] A different rule which applies to revenue-sharing transactions is described below at page 5.

attempts to discover whether the transaction is an excess benefit transaction. Participation includes silence or inaction where the manager is under a duty to speak or act. Therefore, a manager who disagrees with a proposed compensation package or other transaction must vote against the transaction and ask that the minutes record by name the managers who voted against the transaction. A manager may, but is not required to, rely on a reasoned written legal opinion of counsel (including in-house counsel) that a transaction is not an excess benefit transaction. The definition of an "organization manager" is discussed below at page 4.

## DEFINITION OF APPLICABLE TAX-EXEMPT ORGANIZATION

An "applicable tax-exempt organization" is any organization that, without regard to any excess benefit, would be described in section 501(c)(3) (which includes all publicly supported charitable organizations such as churches, schools, hospitals, community foundations, and donor-advised funds) or section 501(c)(4) (which includes civic organizations, social welfare organizations, and local associations of employees) and any organization that was so described during the five-year period ending on the date of the excess benefit transaction.[3] Private foundations are excluded from the definition because they are already subject to analogous taxes under sections 4941-4945. Foreign organizations that receive substantially all of their support from sources outside the United States are also excluded from the definition.

## DEFINITION OF A DISQUALIFIED PERSON

A "disqualified person" is any person who was in a position to exercise substantial influence over an organization at any time during a five-year "lookback" period ending on the date of the transaction.[4] The proposed regulations provide a definition of persons who may exercise substantial influence. They include (i) persons serving on the governing board and entitled to vote, (ii) presidents, chief executive or chief operating officers, treasurers, chief financial officers, and those who have responsibilities generally accompanying these positions, regardless of title, and (iii) persons with a material financial interest in a provider-sponsored organization. In addition, the term disqualified person includes family members of a disqualified person and entities that are more than 35 percent controlled by a disqualified person. Significantly and helpfully, the proposed regulations exclude from the definition of disqualified persons (i) other applicable section 501(c)(3) organizations and (ii) employees

[3] In the case of a transaction occurring before September 14, 2000, the lookback period begins on September 14, 1995, and ends on the date of the transaction.

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receiving economic benefits of less than a specified amount (currently $80,000) who are not substantial contributors to the organization and who are not otherwise disqualified persons.

In addition, the proposed regulations set out a facts-and-circumstances test to determine "substantial influence." Facts tending to show that a person has "substantial influence" include that the person (i) founded the organization, (ii) is a substantial contributor, (iii) is compensated based on revenues from activities of the organization that the person controls, (iv) has authority to control or determine a significant portion of the organization's capital expenditures, operating budget, or employee compensation, (v) has managerial authority, or (vi) owns a controlling interest in a corporation, partnership, or trust that is a disqualified person. Facts that show that a person does not have substantial influence include that the person (i) has taken a vow of poverty on behalf of a religious organization, (ii) is an independent contractor such as an attorney or an accountant, or (iii) only receives preferential treatment that is also offered to any other donor making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions. In the case of organizations that are affiliated by common control, the determination of whether a person has substantial influence is made separately for each applicable tax-exempt organization.

The proposed regulations provide examples of persons with substantial influence. For example, the regulations provide that a doctor who heads a hospital's cardiology department is in a position to exert substantial influence with respect to the hospital where the department is a principal source of revenue for the hospital, and the doctor exerts managerial control over the department. Similarly, the dean of a law school is a disqualified person with respect to the university where the university relies on the law school's reputation to attract students and donors. In another example, however, a radiologist who is employed by a large hospital but (i) has no managerial authority over any part of the hospital or its operations, (ii) does not serve as a director or officer of the hospital, (iii) is not a founder or substantial contributor, (iv) does not receive compensation based on revenues of the hospital that he controls, and (v) has no authority to control or determine a significant portion of the hospital's capital expenditures, operating budget, or compensation for employees, is found not to have substantial influence over the hospital. In that example, the radiologist gives instructions to staff with respect to radiology work and participates in a provider-sponsored organization. An additional example provides that where a for-profit company has managerial control over an exempt organization's main source of revenue (*e.g.*, bingo), the company will be deemed to have substantial influence over the organization. This example shows how a for-profit company can be punished if it improperly strips earnings from a not-for-profit organization. In another example, a management company that manages a limited liability company which operates hospitals is a disqualified person with respect to a tax-exempt organization that is a member of the limited liability company.

## DEFINITION OF AN ORGANIZATION MANAGER

An "organization manager" is any officer, director, trustee, or any individual having similar powers or responsibilities. A person is considered to be an officer if the person is so designated in the governing documents of the organization or the person regularly exercises general authority to make administrative or policy decisions. Independent contractors such as lawyers and accountants are not officers. Similarly, any person who has authority to recommend decisions, but not to implement them without approval of a superior, is not an officer. An individual who serves on a committee invoking the rebuttable presumption (discussed below at page 6) is deemed to be an organization manager for purposes of this provision.

## DEFINITION OF AN EXCESS BENEFIT TRANSACTION

An "excess benefit transaction" is defined as any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly (*e.g.*, through a taxable subsidiary) to or for the use of a disqualified person if the value of the benefit exceeds the value of the consideration received for providing the benefit. The proposed regulations provide that the following economic benefits are disregarded: (i) reimbursement for reasonable expenses of attending board meetings (not including luxury or spousal travel); (ii) benefits provided to a disqualified person solely as a member of or volunteer for the organization; and (iii) benefits received solely as a member of a charitable class.

Payment of reasonable compensation is not an excess benefit transaction. The proposed regulations state that compensation is reasonable if it is no more than the amount that would "ordinarily be paid for like services by like enterprises under like circumstances." This definition puts pressure on directors to investigate the comparability of the services, organizations, and circumstances under review before voting for or against a compensation package. The fact that a State or local government body approves a compensation package is not determinative of reasonableness. Compensation includes salary, bonuses, severance payments, deferred compensation that is earned and vested, the amount of premiums paid for director and officer insurance (including insurance to cover excess benefit penalty taxes), and all other benefits, whether or not included in income for tax purposes, including payments to welfare benefit plans, health and life insurance coverage, and taxable and nontaxable fringe benefits.

An organization needs to provide clear and convincing contemporaneous evidence that it intended to provide a benefit as compensation for services. Evidence includes reporting the benefit as compensation on the organization's federal tax information returns (Form W-2, 1099 or 990) or on the recipient's income tax returns.

## SPECIAL RULES FOR REVENUE-SHARING TRANSACTIONS

A "revenue-sharing transaction" is one in which the benefit provided to the disqualified person is determined in whole or in part by the revenues of one or more activities of the organization. A revenue-sharing transaction may constitute an excess benefit transaction regardless of whether the economic benefit received exceeds the fair market value of the consideration provided, if the transaction permits a disqualified person to receive additional compensation without providing proportional benefits that contribute to an organization's exempt purpose. The proposed regulations provide that in this case, the entire amount of compensation is considered an excess benefit. This rule applies only to revenue-sharing transactions occurring after the proposed regulations are finalized.

An example in the proposed regulations provides that the following revenue-sharing transaction does not constitute an excess benefit transaction: A tax-exempt organization employs a professional investment manager, who works solely for the organization. The investment manager's compensation consists of a base salary, health insurance, retirement benefits, and a bonus equal to a percentage of any increase in the value of the organization's portfolio over the year (net of expenses). Although the manager controls the activities on which her bonus is based, she can increase her own compensation only if the organization receives a proportional benefit. It is noteworthy that this example is favorable, even though the compensation is not capped at a particular dollar amount. In contrast, another example illustrates an excess benefit transaction: An organization enters into a contract with a company that manages charitable gaming activities, as a result of which the management company becomes a disqualified person. The management company carries out the charitable gaming operations on behalf of the organization and pays the organization a percentage of net profits (calculated as gross revenue less operating expenses). The management company retains the balance of the proceeds. Because the management company controls both the gross revenues earned and the rate at which it bills the expenses it incurred, it benefits whether revenues and expenses are high or low. In contrast, the charity suffers if expenses are high and revenues are low. This arrangement results in the inurement of the charity's net earnings to the company, and the entire amount paid to the management company constitutes a taxable excess benefit.

## THE REBUTTABLE PRESUMPTION: A SAFE-HARBOR PROCEDURE

As expected, the proposed regulations contain a procedure boards can follow to create a presumption that compensation payments, transfers of property, or other benefits to disqualified persons are reasonable. If a board follows this procedure, the burden of proof shifts to the IRS to prove that the payments or other benefits are unreasonable. The procedure contains three steps. First, the governing board or a committee of the board must obtain and review appropriate data as to comparable transactions. Second, the payments or transactions must be preapproved by the board or a committee of the board composed entirely of individuals who do not have a conflict of interest with respect to the payment or transaction. Third, the board or committee must document the basis for its determination. If permitted under local law, the board may authorize others to follow this procedure.

Appropriate data for these purposes include details of compensation paid by similarly situated organizations, both taxable and tax-exempt, for comparable positions, the availability of similar services in the area, independent compensation surveys, actual written offers for the disqualified person's services, and independent appraisals of the value of any property involved. The board or committee must document (i) the terms of the transaction, (ii) the date it was approved, (iii) the members of the board or committee who were present and those who voted for the transaction, (iv) the comparability data and how it was obtained, and (v) the actions taken by persons who had conflicts of interest. Documentation must be prepared no later than the next meeting of the board or committee occurring after the meeting at which the transaction is approved.

An example in the proposed regulations dealing with the compensation of a university president shows that a national survey that does not divide its data by university size or other criteria is not appropriate data as to comparability. However, a survey that is sorted by different variables, including size and services of the organizations surveyed, the level of experience and specific responsibilities of the executives, and the composition of their compensation packages, is appropriate data as to comparability.

A special rule in the proposed regulations provides that an organization with annual gross receipts of less than $1 million may rely on details of compensation paid by five comparable organizations. An example provides that the board of a local repertory theater with annual gross receipts of less than $1 million may rely on salary data compiled from a telephone survey of six other unrelated repertory theaters of similar size in various communities throughout the same geographic region. The compensation decision is documented by a member of the board, who prepares a written report including the survey results, information about the membership of the board, and an evaluation of the artistic director's prior salary and performance that is discussed and voted on by the board. By negative implication, where an organization's gross receipts are in excess of $1 million, the compensation study must be more detailed, look at more organizations, and be conducted more formally.

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If you have any questions about specific situations or would like further information or assistance regarding any provisions of the proposed regulations, please call Victoria B. Bjorklund (212-455-2875), Christina L. Nooney (212-455-2740), or Jennifer I. Goldberg (212-455-2668) of our Exempt Organizations Group.

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