EASIER COMPLIANCE IS GOAL OF NEW INTERMEDIATE SANCTION REGULATIONS

By Steven T. Miller [1]

On January 10, 2001, the Treasury Department issued Temporary Regulations interpreting the benefit limitation provisions of Section 4958 of the Internal Revenue Code. These provisions are important to the exempt organization community as a whole, and to those of us with responsibility for ensuring compliance in this area.

Proposed intermediate sanction regulations were issued in 1998. Since that time, staff from my office, the Office of Chief Counsel, and the Office of Tax Policy received and analyzed comments from the public. We incorporated many suggestions into the new Regulations. I believe the Regulations remain true to the language and legislative history of the statute.

Because of the number of changes incorporated, the new Regulations were issued in temporary form. As such, they have the same force and effect as final regulations for up to three years. However, I have no doubt that during this three-year period, you will continue to share your thoughts on the new Regulations. This is a healthy process and I am confident that this process will ensure that the final regulations will incorporate interpretations that are easy for taxpayers to follow and efficient for the Service to administer.

The new Regulations are lengthy—they cover all provisions of Section 4958 applicable to the various benefits exempt organization officials receive. I am providing this brief analysis hoping to make the Regulations easier to understand and follow. In my view, the primary purpose of the statute and the regulations is not solely to give the Service another tool in its enforcement arsenal, but to provide a roadmap by which an organization may steer clear of situations that may give rise to inurement. Needless to say, my analysis reflects my own views and does not necessarily represent the official views of the Treasury Department or the Internal Revenue Service.

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1. The Regulations Only Apply to 501(c)(3) and 501(c)(4) Organizations

It is important to emphasize that the Regulations only apply to certain "applicable" section 501(c)(3) and 501(c)(4) organizations. An applicable tax-exempt organization is a section 501(c)(3) or a section 501(c)(4) organization that is tax-exempt under section 501(a), or was such an organization at any time during a five-year period ending on the day of the excess benefit transaction. An applicable tax-exempt organization does not include:

- A private foundation as defined in section 509(a).
- A governmental entity that is exempt from (or not subject to) taxation without regard to section 501(a).
- Certain foreign organizations.

An organization is not treated as a section 501(c)(3) or 501(c)(4) organization for any period covered by a final determination that the organization was not tax-exempt under section 501(a), but only if the determination was not based on private inurement or one or more excess benefit transactions.

2. Section 4958 Only Applies to Certain Influential or "Disqualified" Persons

The vast majority of section 501(c)(3) or 501(c)(4) organization employees and contractors will not be affected by the section 4958 Regulations. Only the few influential persons within these organizations are covered by the Regulations when they receive benefits, such as compensation, fringe benefits, or contract payments. The IRS calls this class of covered individuals "disqualified persons." A disqualified person, regarding any transaction, is any person who was in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization at any time during a five-year period ending on the date of the transaction. Persons who hold certain powers, responsibilities, or interests are among those who are in a position to exercise substantial influence over the affairs of the organization. This would include, for example, voting members of the governing body, and persons holding the power of:

- Presidents, chief executive officers, or chief operating officers.
- Treasurers and chief financial officers.

A disqualified person also includes certain family members of a disqualified person, and 35% controlled entities of a disqualified person.

3. Persons Who Are Not Disqualified

The Regulations also clarify which persons are not considered to be in a position to exercise substantial influence over the affairs of an organization. They include:

- An employee who receives benefits that total less than the "highly compensated" amount in section 414(q)(1)(B)(i) ($85,000 in 2001) and who does not hold the executive or voting powers just mentioned; is not a family member of a disqualified person; and is not a substantial contributor;
- Tax-exempt organizations described in section 501(c)(3); and
- Section 501(c)(4) organizations with respect to transactions engaged in with other section 501(c)(4) organizations.

4. Other Persons Are Subject to a Facts and Circumstances Test

Other persons not described in Sections 2 or 3 above can also be considered disqualified persons, depending on all the relevant facts and circumstances.

Facts and circumstances tending to show substantial influence:

- The person founded the organization.
- The person is a substantial contributor to the organization under the section 507(d)(2)(A) definition, only taking into account contributions to the organization for the past 5 years.
- The person's compensation is primarily based on revenues derived from activities of the organization that the person controls.
- The person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees.
- The person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole.
- The person owns a controlling interest (measured by either vote or value) in a corporation, partnership, or trust that is a disqualified person.
- The person is a non-stock organization controlled directly or indirectly by one or more disqualified persons.

Facts and circumstances tending to show no substantial influence:

- The person is an independent contractor whose sole relationship to the organization is providing professional advice (without having decision-making authority) with respect to transactions from which the independent contractor will not economically benefit.
- The person has taken a vow of poverty.
- Any preferential treatment the person receives based on the size of the person's donation is also offered to others making comparable widely solicited donations.
- The direct supervisor of the person is not a disqualified person.
- The person does not participate in any management decisions affecting the organization as a whole or a discrete segment of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole.

Persons Staffing Affiliated Organizations

In the case of multiple affiliated organizations, the determination of whether a person has substantial influence is made separately for each applicable tax-exempt organization. A person may be a disqualified person with respect to transactions with more than one organization.

5. Section 4958 Only Applies to "Excess Benefit" Transactions of Disqualified Persons.

Fair market value determines whether the tax exempt organization provides an excess benefit to a disqualified person -- An excess benefit transaction is a transaction in which an economic benefit is provided by an applicable tax-exempt organization, directly or indirectly, to or for the use of any disqualified person, and the value of the economic benefit provided by the organization exceeds the value of the consideration (including the performance of services) received for providing such benefit.

To determine whether an excess benefit transaction has occurred, all consideration and benefits exchanged between a disqualified person and the applicable tax-exempt organization, and all entities it controls, are taken into account. For purposes of determining the value of economic benefits, the value of property, including the right to use property, is the fair market value. Fair market value is the price at which property, or the right to use property, would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell or transfer property or the right to use property, and both having reasonable knowledge of relevant facts.

An excess benefit can occur in an exchange of compensation and other compensatory benefits in return for the services of a disqualified person, or in an exchange of property between a disqualified person and the exempt organization.

6. Compensation Provided by Tax Exempts Is Not Excessive if "Reasonable"

Reasonable compensation is the value that would ordinarily be paid for like services by like enterprises under like circumstances. This is the section 162 standard that will apply in determining the reasonableness of compensation. The fact that a bonus or revenue-sharing arrangement is subject to a cap is a relevant factor in determining the reasonableness of compensation.

For determining the reasonableness of compensation, all items of compensation provided by an applicable tax-exempt organization in exchange for the performance of services are taken into account in determining the value of compensation (except for certain economic benefits that are disregarded, as discussed at paragraph 8 below). Items of compensation include:

- All forms of cash and non-cash compensation, including salary, fees, bonuses, severance payments, and deferred and noncash compensation;
- The payment of liability insurance premiums for, or the payment or reimbursement by the organization of taxes or certain expenses under section 4958, unless excludable from income as a de minimus fringe benefit under section 132(a)(4). (A similar rule applies in the private foundation area.) Inclusion in compensation for purposes of determining reasonableness under section 4958 does not control inclusion in income for income tax purposes.
- All other compensatory benefits, whether or not included in gross income for income tax purposes.
- Taxable and nontaxable fringe benefits, except fringe benefits described in section 132.
- Foregone interest on loans.

7. Written Intent Required to Treat Benefits As Compensation.

An economic benefit is not treated as consideration for the performance of services unless the organization providing the benefit clearly indicates its intent to treat the benefit as compensation when the benefit is paid.

An applicable tax-exempt organization (or entity that it controls) is treated as clearly indicating its intent to provide an economic benefit as compensation for services only if the organization provides written substantiation that is contemporaneous with the transfer of

the economic benefits under consideration. Ways to provide contemporaneous written substantiation of its intent to provide an economic benefit as compensation include:

- The organization produces a signed written employment contract;

- The organization reports the benefit as compensation on an original Form W-2, Form 1099 or Form 990, or on an amended form filed prior to the start of an IRS examination; or

- The disqualified person reports the benefit as income on the person's original Form 1040 or on an amended form filed prior to the start of an IRS examination.

- *Exception.* To the extent the economic benefit is excluded from the disqualified person's gross income for income tax purposes, the applicable tax-exempt organization is not required to indicate its intent to provide an economic benefit as compensation for services. (For example: employer provided health benefits, and contributions to qualified plans under section 401(a).)

8. Disregarded Benefits

The following economic benefits are disregarded for purposes of section 4958:

- Nontaxable fringe benefits: An economic benefit that is excluded from income under section 132.
- Benefits to volunteer: An economic benefit provided to a volunteer for the organization if the benefit is provided to the general public in exchange for a membership fee or contribution of $75.00 or less per year.
- Benefits to members or donors: An economic benefit provided to a member of an organization due to the payment of a membership fee, or to a donor as a result of a deductible contribution, if a significant number of nondisqualified persons make similar payments or contributions and are offered a similar economic benefit.
- Benefits to a charitable beneficiary: An economic benefit provided to a person solely as a member of a charitable class that the applicable tax-exempt organization intends to benefit as part of the accomplishment of its exempt purpose.
- Benefits to a governmental unit: A transfer of an economic benefit to or for the use of a governmental unit, as defined in section 170(c)(1), if exclusively for public purposes.

9. Special Exception for Initial Contracts

Section 4958 does not apply to any “fixed payment” made to a person pursuant to an initial contract. This is a very important exception, since it would potentially apply, for example, to all initial contracts with new, previously unrelated officers and contractors.

An “initial contract” is a binding written contract between an applicable tax-exempt organization and a person who was not a disqualified person immediately prior to entering into the contract.

A “fixed payment” is an amount of cash or other property specified in the contract, or determined by a fixed formula that is specified in the contract, which is to be paid or transferred in exchange for the provision of specified services or property.

A “fixed formula” may, in general, incorporate an amount that depends upon future specified events or contingencies, as long as no one has discretion when calculating the amount of a payment or deciding whether to make a payment (such as a bonus).

Treatment as New Contract: A binding written contract providing that it may be terminated or cancelled by the applicable tax-exempt organization without the other party’s consent (except as a result of substantial non-performance) and without substantial penalty, is treated as a new contract, as of the earliest date that any termination or cancellation would be effective. Also, a contract in which there is a “material change,” which includes an extension or renewal of the contract (except for an extension or renewal resulting from the exercise of an option by the disqualified person), or a more than incidental change to the amount payable under the contract, is treated as a new contract as of the effective date of the material change. Treatment as a new contract may cause the contract to fall outside the initial contract exception, and it thus would be tested under the fair market value standards of section 4958.

10. Tax-Exempts Can Create a Rebuttable Presumption of Reasonableness

We understand how concerned many tax-exempt officials may be that they could be forced to reach into their pockets and come up with substantial taxes and interest because a mistake was made in determining or recording their compensation and other benefits. Congress was aware of these concerns, and thus proposed a type of safe harbor—a “rebuttable presumption”—in the legislative history. We have incorporated this presumption in the new regulations in the form of a step-by-step, “cookbook” procedure. Following this “recipe” will require some time and effort, but it should be relatively easy in most cases and will give the organization’s disqualified persons substantial comfort and confidence.

Payments under a compensation arrangement are presumed to be reasonable and the transfer of property (or right to use property) is presumed to be at fair market value, if the following three conditions are met.

- The transaction is approved by an authorized body of the organization (or an entity it controls) which is composed of individuals who do not have a conflict of interest concerning the transaction.
- Prior to making its determination, the authorized body obtained and relied upon appropriate data as to comparability. There is a special safe harbor for small organizations -- if the organization has gross receipts of less than $1 million, appropriate comparability data includes data on compensation paid by three comparable organizations in the same or similar communities for similar services.
- The authorized body adequately documents the basis for its determination concurrently with making that determination. The documentation should include:

  (i) The terms of the approved transaction and the date approved;
  (ii) The members of the authorized body who were present during debate on the transaction that was approved and those who voted on it;
  (iii) The comparability data obtained and relied upon by the authorized body and how the data was obtained;
  (iv) Any actions by a member of the authorized body having a conflict of interest; and
  (v) Documentation of the basis for the determination before the later of the next meeting of the authorized body or 60 days after the final actions of the authorized body are taken, and approval of records as reasonable, accurate and complete within a reasonable time thereafter.

11. Special Rebuttable Presumption Rule for Non-Fixed Payments

As a general rule, in the case of a non-fixed payment, no rebuttable presumption arises until the exact amount of the payment is determined, or a fixed formula for calculating the payment is specified, and the three requirements creating the presumption have been satisfied. However, if the authorized body approves an employment contract with a disqualified person that includes a non-fixed payment (e.g., discretionary bonus) with a specified cap on the amount, the authorized body may establish a rebuttable presumption as to the non-fixed payment when the employment contract is entered into by, in effect, assuming that the maximum amount payable under the contract will be paid, and satisfying the requirements giving rise to the rebuttable presumption for that maximum amount.

12. The IRS Has the Burden of Overcoming the Presumption

The Internal Revenue Service may refute the presumption of reasonableness only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body. This provision gives taxpayer's added protection if they faithfully find and use *contemporaneous* persuasive comparablility data when they provide the benefits.

13. Organizations Not Establishing Presumption Can Still Comply with Section 4958

In some cases, an organization may find it impossible or impracticable to fully implement each step of the rebuttable presumption process described above. In such cases, the organization should try to implement as many steps as possible, in whole or in part, in order to substantiate the reasonableness of benefits as timely and as well as possible. If an organization does not satisfy the requirements of the rebuttable presumption of reasonableness, a facts and circumstances approach will be followed, using established rules for determining reasonableness of compensation and benefit deductions in a manner similar to the established procedures for section 162 business expenses.

14. The Excess Benefit Usually Occurs on the Date the Disqualified Person Receives the Benefit

An excess benefit transaction occurs on the date the disqualified person receives the economic benefit from the organization for Federal income tax purposes. However, when a single contractual arrangement provides for a series of compensation payments or other payments to a disqualified person during the disqualified person's taxable year, any excess benefit transaction with respect to these payments occurs on the last day of the taxpayer's taxable year.

In the case of the transfer of property subject to a substantial risk of forfeiture, or in the case of rights to future compensation or property, the transaction occurs on the date the property, or the rights to future compensation or property, is not subject to a substantial risk of forfeiture. Where the disqualified person elects to include an amount in gross income in the taxable year of transfer under section 83(b), the excess benefit transaction occurs on the date the disqualified person receives the economic benefit for Federal income tax purposes.

15. Excise Taxes under Section 4958

Tax on Disqualified Persons

An excise tax equal to 25% of the excess benefit is imposed on each excess benefit transaction between an applicable tax-exempt organization and a disqualified person. The disqualified person who benefited from the transaction is liable for the tax. If the 25% tax is imposed and the excess benefit transaction is not corrected within the taxable period, an additional excise tax equal to 200% of the excess benefit is imposed.

If a disqualified person makes a payment of less than the full correction amount, the 200% tax is imposed only on the unpaid portion of the correction amount. If more than one disqualified person received an excess benefit from an excess benefit transaction, all such disqualified persons are jointly and severally liable for the taxes.

To avoid the imposition of the 200% tax, a disqualified person must correct the excess benefit transaction during the taxable period. The taxable period begins on the date the transaction occurs and ends on the earlier of the date the statutory notice of deficiency is issued or the section 4958 taxes are assessed. This 200% tax may be abated if the excess benefit transaction subsequently is corrected during a 90-day correction period.

Tax on Organization Managers

An excise tax equal to 10% of the excess benefit may be imposed on the participation of an organization manager in an excess benefit transaction between an applicable tax-exempt organization and a disqualified person. This tax, which may not exceed $10,000 with respect to any single transaction, is only imposed if the 25% tax is imposed on the disqualified person, the organization manager knowingly participated in the transaction, and the manager's participation was willful and not due to reasonable cause. There is also joint and several liability for this tax. A person may be liable for both the tax paid by the disqualified person and this organization manager tax in appropriate circumstances.

An organization manager is any officer, director, or trustee of an applicable tax-exempt organization, or any individual having powers or responsibilities similar to officers, directors, or trustees of the organization, regardless of title. An organization manager is not considered to have participated in an excess benefit transaction where the manager has opposed the transaction in a manner consistent with the fulfillment of the manager's responsibilities to the organization. For example, a director who votes against giving an excess benefit would ordinarily not be subject to this tax.

A person participates in a transaction knowingly if the person has actual knowledge of sufficient facts so that, based solely upon such facts, the transaction would be an excess benefit transaction. Knowing does not mean having reason to know. The organization manager ordinarily will not be considered knowing if, after full disclosure of the factual situation to an appropriate professional, the organization manager relied on the professional's reasoned written opinion on matters within the professional's expertise or if the manager relied on the fact that the requirements for the rebuttable presumption of reasonableness have been satisfied. Participation by an organization manager is willful if it is voluntary, conscious and intentional. An organization manager's participation is due to reasonable cause if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence.

16. Correcting the Excess Benefit

A disqualified person corrects an excess benefit transaction by undoing the excess benefit to the extent possible, and by taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards. The organization is not required to rescind the underlying agreement; however, the parties may need to modify an ongoing contract with respect to future payments.

A disqualified person corrects an excess benefit by making a payment in cash or cash equivalents equal to the correction amount to the applicable tax-exempt organization. The correction amount equals the excess benefit plus the interest on the excess benefit; the interest rate may be no lower than the applicable Federal rate. There is an anti-abuse rule to prevent the disqualified person from effectively transferring property other than cash or cash equivalents.

<u>Property</u>. With the agreement of the applicable tax-exempt organization, a disqualified person may make a payment by returning the specific property previously transferred in the excess benefit transaction. The return of the property is considered a payment of cash (or cash equivalent) equal to the lesser of:

- The fair market value of the property on the date the property is returned to the organization, or
- The fair market value of the property on the date the excess benefit transaction occurred.

<u>Insufficient Payment</u>. If the payment resulting from the return of the property is less than the correction amount, the disqualified person must make an additional cash payment to the organization equal to the difference.

Excess Payment. If the payment resulting from the return of the property exceeds the correction amount described above, the organization may make a cash payment to the disqualified person equal to the difference.

17. Application of Section 4958 to Churches

The regulations make it clear that the IRS will apply the procedures of section 7611 when initiating and conducting any inquiry or examination into whether an excess benefit transaction has occurred between a church and a disqualified person.

18. Section 4958 Applies Only to Post-September 1995 Transactions

Section 4958 applies to excess benefit transactions occurring on or after September 14, 1995. Section 4958 does not apply to any transaction occurring pursuant to a written contract that was binding on September 13, 1995, and at all times thereafter before the transaction occurs.

19. Revenue Sharing Transactions Are Subject to the Same Rules as Other Compensatory Arrangements

The proposed regulations had special provisions covering "any transaction in which the amount of any economic benefit provided to or for the use of a disqualified person is determined in whole or in part by the revenues of one or more activities of the organization. . ."— so-called "revenue-sharing transactions." Numerous comments were received on this section of the proposed regulations. Rather than setting forth additional rules on revenue-sharing transactions, the temporary regulations reserve this section. Consequently, unless the Service issues new proposed regulations providing additional rules for revenue-sharing transactions, these transactions will be evaluated under the general rules of the temporary regulations (i.e., the fair market value standards) that apply to all contractual arrangements between applicable tax-exempt organizations and their disqualified persons.

20. Section 4958 Does Not Replace Revocation of Exemption

Section 4958 does not affect the substantive standards for tax exemption under section 501(c)(3) or section 501(c)(4), including the requirements that the organization be organized and operated exclusively for exempt purposes, and that no part of its net earnings inure to the benefit of any private shareholder or individual. The legislative history

indicates that in most instances, the imposition of this intermediate sanction will be in lieu of revocation. IRS has indicated that the following four factors will be considered in determining whether to revoke an applicable tax-exempt organization's exemption status where an excess benefit transaction has occurred:

- Whether the organization has been involved in repeated excess benefit transactions;
- The size and scope of the excess benefit transaction;
- Whether, after concluding that it has been party to an excess benefit transaction, the organization has implemented safeguards to prevent future recurrences; and
- Whether there was compliance with other applicable laws.

21. Conclusion

While summary in nature, I hope that the above explanation will help you understand and comply with the new Regulations. For further explanation, you should refer to the thorough "Explanation of Provisions" that precedes the text of the Regulations in the official published version.

During the coming months, Service officials will be speaking on the regulations. I hope you will avail yourself of the opportunity to pose questions and comments in these forums. Again, I welcome your comments and suggestions; your feedback will enable us to craft the most effective final regulations.