Excess Benefit and Reasonable Compensation:

An Analysis of the Intermediate Sanctions Rules

American College of Healthcare Executives
for leaders who care®

American Hospital Association

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Introduction

In 1996, Congress enacted the Taxpayer Bill of Rights 2. (See §§ 4958 63 of the Internal Revenue Code of 1986, as amended.) Under these statutory provisions, the Internal Revenue Service (IRS) for the first time was authorized to impose "intermediate sanctions" on various individuals who use the assets of a Section 501(c)(3) or 501(c)(4) tax-exempt organization for improper personal gain. Accordingly, the intermediate sanctions rules expose to personal liability certain insiders, called disqualified persons, and exempt organization managers. Prior to enactment of the intermediate sanctions law, the only option for the IRS to sanction improper transactions between the organization and its insiders was revocation of the organization's tax-exempt status – a drastic step that the IRS often was hesitant to take as disproportionate to the offense.

On January 22, 2002, the IRS released final regulations (the Final Regulations) that are effectively the same as the temporary regulations issued on January 10, 2001 (the Temporary Regulations), with some additional clarifications.[1] While the Final Regulations are important for all 501(c)(3) and 501(c)(4) organizations, they should be of particular interest to such organizations that are involved in financial transactions with executives or Board members or that pay substantial compensation to executives.

Under the express terms of Section 4958, if a 501(c)(3) public charity or a 501(c)(4) social welfare organization and one or more disqualified persons engage in an excess benefit transaction, both the disqualified persons and the organization managers who approved the transaction may be subject to significant sanctions in the form of penalty excise taxes. More specifically, disqualified persons initially are subject to a tax of 25 percent of the amount of excess benefit derived from a transaction with an applicable exempt organization, and are further subject to an additional tax of 200 percent of the amount of excess benefit if not "corrected" within a designated time period. In addition, exempt organization managers are subject to a tax of 10 percent of the excess benefit if they knowingly participate in an excess benefit transaction, unless the participation was not willful and was due to reasonable cause.

This brief outlines the IRS' Final Regulations on intermediate sanctions.

Excess Benefit Transaction

An excess benefit transaction is defined in the Final Regulations as any transaction in which an economic benefit is provided by an applicable tax-exempt organization, directly or indirectly, to a disqualified person that exceeds the value of the consideration (including the performance of services) received by the organization. Furthermore, an excess benefit may be provided indirectly by an exempt organization to a disqualified person through:

- a controlled entity; or
- an intermediary (as discussed below).

The Final Regulations also retain the "initial contract" exception (sometimes referred to by commentators as a "one free bite" rule), whereby the intermediate sanctions rules are not applied to any fixed payment made pursuant to a binding written contract between the applicable exempt organization and a party who was not a disqualified person immediately prior to entering into the contract (as discussed below).

Applicable Tax-exempt Organization

As noted above, the intermediate sanctions apply to transactions with applicable tax-exempt organizations, which include any 501(c)(3) public charity (private foundations are excluded) or 501(c)(4) social welfare organization, and any organizations that have been so exempt at any time during a five-year period ending on the date of an excess benefit transaction (the "lookback period").[2] In addition, an organization that has applied for exemption or filed an information return as a 501(c)(4) organization, or has otherwise held itself out as being described in 501(c)(4), is an applicable tax-exempt organization for purposes of the intermediate sanctions.[3] The intermediate sanctions rules, however, are not applicable to governmental entities such as state universities that are exempt from or not subject to taxation without regard to Section 501(a) or are relieved from filing an annual return pursuant to regulations under Section 6033 – even if such institutions also have obtained tax-exempt status under Section 501(c)(3).

Disqualified Person

As defined in Section 4958 and the Final Regulations, a disqualified person is any person who was in a position to exercise substantial influence over the affairs of the organization at any time during the five-year period ending on the date of the transaction. As described below, the Final Regulations specify certain individuals who are deemed to have substantial influence and others who are deemed not to have substantial influence. Disqualified persons also include:

- a member of the family of a person who was in a position to exercise such influence;[4] and
- an entity controlled 35 percent or more by disqualified persons.[5]

In all other cases, a determination of whether a person has substantial influence is based on a facts and circumstances inquiry.

Persons Having Substantial Influence

The Final Regulations provide that a person is in a position to exercise substantial influence over an organization if that person has the powers or responsibilities, or holds the type of interests, described in one of the following categories (such individuals will be "per se" disqualified persons because of their actual powers and responsibilities and not by virtue of their titles or positions). They include:

- Individuals serving on the governing body who are entitled to vote.
- Presidents, chief executive officers or chief operating officers: An individual may serve in one of these capacities, regardless of title, if that person has or shares ultimate responsibility for implementing the decisions of the governing body or supervising the management, administration or operation of the applicable organization.
- Treasurers and chief financial officers: An individual may serve in one of these capacities, regardless of title, if that individual has or shares ultimate responsibility for managing the organization's financial assets.
- Persons with a material financial interest in a provider-sponsored organization if a hospital that participates in the provider-sponsored organization is an applicable tax-exempt organization.

Persons Deemed Not To Have Substantial Influence

The Final Regulations also provide specific categories of persons deemed not to be in a position of substantial influence over the organization. These persons include:

- any other applicable tax-exempt organization described in Code Section 501(c)(3);
- with respect to a 501(c)(4) organization subject to the intermediate sanctions rules, any other "applicable tax-exempt organization" described in Code Section 501(c)(4);[6] and

- employees of the applicable tax-exempt organization who, within the taxable year in which benefits are provided: (a) receive economic benefits (directly or indirectly) less than the amount of compensation referenced for a highly compensated employee;[7] (b) do not fall within the statutory categories of disqualified persons; and (c) are not a substantial contributor to the organization.[8]

Facts and Circumstances Test

If a person does not fall within the categories described above, the determination of whether he or she is a disqualified person depends on all of the facts and circumstances. The Final Regulations outline non-exclusive lists of facts and circumstances tending to show whether a person does or does not have substantial influence over an organization.

Facts and circumstances tending to show substantial influence include:

- the person founded the organization;
- the person is a substantial contributor to the organization;[9]
- 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 has managerial control over a discrete segment of the applicable exempt organization and that segment represents a substantial portion of an applicable exempt organization's activities, assets, income or expenses (e.g., the head of the cardiology department at a hospital is a disqualified person where that particular department is a principal source of patients and revenue for the hospital);
- the person owns a controlling interest (measured by vote or value) in a corporation, partnership or a trust that is a disqualified person; or
- 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 include:

- the person has taken a bona fide vow of poverty as an employee, agent or on behalf of a religious organization;
- the person is an independent contractor, such as an attorney, accountant or investment manager or advisor, whose sole relationship to the organization is providing professional advice, unless the person is acting in that capacity with respect to a transaction from which the person might economically benefit either directly or indirectly (aside from customary fees received for the professional services rendered);
- the person's direct supervisor is an individual who is not a disqualified person;
- the person does not participate in management decisions affecting the applicable exempt organization in its entirety or a discrete but substantial segment or activity of the organization that represents a substantial portion of the activities, assets, income or expenses of the organization;
- the person has no prior involvement with the exempt organization with respect to an initial contract (as discussed more fully below); or
- any preferential treatment a person receives based on the size of that person's donation if also offered to any other donor making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions.

The Final Regulations include 13 examples analyzing facts and circumstances to determine whether a person is a disqualified person. The examples include a non-highly compensated employee of a community organization, a highly compensated employee of a community organization, a limited-voting member of a 501(c)(3) organization with broad-public membership, the headmaster of a school, a gaming management company, a majority stockholder of a tax-exempt gaming management company, a for-profit hospital management company managing a whole hospital joint venture, the dean of a law school that is part of a large university, the chairman of a small academic department that is part of a large university, a hospital-employed radiologist, a cardiologist who is head of a hospital's cardiology department, an outside accountant, and a substantial contributor to a theater. Each example illustrates the analysis for determining whether a person is in a position to exercise substantial influence over an organization. Among other things, the Final Regulations revised one example to clarify that an exempt organization's management company is a per se disqualified person where the management company is ultimately responsible for management of the hospital (consistent with the functions of a president, CEO or COO), whereas under the Temporary Regulations, a management company's status as a disqualified person would have been determined based on the facts and circumstances.

Excess Benefit Transaction Defined

In order for intermediate sanctions to be imposed, there must be an "excess benefit transaction" between the applicable tax-exempt organization and a disqualified person. An excess benefit transaction is any transaction in which an economic benefit is provided by an applicable tax-exempt organization, directly or indirectly, to or for the use of a disqualified person that exceeds the fair market value (FMV) of the consideration (including the performance of services) received by the exempt organization.[10] This definition encompasses the payment of excess compensation to a disqualified person and any other property transfer or transaction between a disqualified person and an applicable tax-exempt organization.

Initial Contract Exception

The Final Regulations retain the "initial contract" exception (sometimes referred to by commentators as the "one free bite" rule), whereby the intermediate sanctions rules are not applied to any <u>fixed payment</u> made pursuant to a binding written contract between the applicable exempt organization and a party who was not a disqualified person <u>immediately prior to entering into the contract (e.g., a newly-hired executive director of an organization)</u>. Payments falling under the initial contract exception are not considered excess benefit transactions. The following concepts form the basis for the initial contract exception:

- A "fixed payment" means an amount of cash or other property that is specified in the contract, or determined by a fixed formula specified in the contract, and which is paid or transferred in exchange for the provision of specific services or property.
- A "fixed formula" may incorporate an amount that depends on future specified events or contingencies (e.g., revenues generated by activities of the organization) provided that no person exercises discretion when calculating the amount of a payment or deciding whether to make a payment (e.g., tying compensation to increases in the Consumer Price Index). If a formula allows for any discretion by any person, the contract will fall outside of the scope of the initial contract exception.[11]
- If an initial contract has both fixed and non-fixed payment components, the non-fixed payment component will not fall under the initial contract exception and should be analyzed under the general rules governing excess benefit transactions.

- The initial contract exception will not apply where the contract is materially changed or if a person fails to substantially perform his or her obligations under the contract. A material change generally includes extensions or renewals and a "more than incidental" change in the amount payable under the contract.
- The Final Regulations provide 11 examples applying the initial contract exception to employment, management and service contracts between applicable exempt organizations and their employees, third-party management companies and scientific research organizations.

Indirect Economic Benefit

An excess benefit may be provided indirectly by an exempt organization to a disqualified person through a controlled entity[12] or through an intermediary. All consideration and benefits exchanged between a disqualified person and an applicable exempt organization, and all entities the exempt organization controls, are taken into account in the aggregate to determine whether there has been an excess benefit transaction. It should be noted that an authorized body of an entity controlled by the exempt organization, even if it is not an applicable exempt organization, can establish the rebuttable presumption of reasonableness (discussed below) for transfers of economic benefits to a disqualified person.

An economic benefit is provided through a third-party intermediary where an applicable exempt organization provides a benefit to a third-party intermediary; the intermediary provides economic benefits to a disqualified person of the exempt organization; and either there is evidence of an oral or written agreement or understanding that the intermediary will transfer property to a disqualified person, or the intermediary has no significant business or exempt purpose of its own to make the transfer to the disqualified person.

Certain Economic Benefits May Be Excluded from Excess Benefit Determination

Certain categories or types of economic benefits may be excluded from a determination of whether a transaction is an excess benefit transaction, even if such benefits have been provided to disqualified persons. They include:

- Non-taxable fringe benefits excluded under Section 132, except for certain liability insurance premium, payments or reimbursements that must be taken in to account (as discussed below).[13]
- Expense reimbursements paid to employees under an "accountable plan," as defined under Treasury Regulations §1.62 2(c)(2).
- Economic benefits provided to a volunteer (who is a disqualified person) if the benefit is provided to the general public in exchange for a membership fee or contribution of $75 or less per year.
- Economic benefits provided to a disqualified person as a member of, or a donor to, an applicable exempt organization, provided that certain requirements are met.
- Economic benefits provided to a person solely because the person is a member of a charitable class that the applicable tax-exempt organization intends to benefit as part of the accomplishment of the organization's exempt purpose.
- Any transfer of an economic benefit to or for the use of a governmental unit, if the transfer is for exclusively public purposes.
- Any payment made pursuant to, and in accordance with, a final individual prohibited transaction exemption issued by the Department of Labor under the Employee Retirement Income Security Act with respect to a transaction involving a plan that is an applicable tax-exempt organization.

Definition of Reasonable Compensation

Compensation paid to a disqualified person will not be regarded as an excess benefit transaction if the total compensation paid (taking into account all benefits other than those specifically excluded above) is reasonable. Reasonable compensation is defined as "an amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances." This determination is generally made based on the circumstances existing at the date when the contract for services was made. Where such a determination cannot be made, the determination is based on all the facts and circumstances up to and including circumstances existing on date of payment. Furthermore, if the contract is materially modified, or if the contract is terminable and subject to cancellation as of a particular date by the organization without the disqualified person's consent, then the contract is treated as a new contract entered into as of the date of modification or termination.

For purposes of determining whether there is an excess benefit transaction, compensation includes, but is not limited to:

- all forms of cash and non-cash compensation, including salary, fees, bonuses and severance payments paid;
- all forms of deferred and non-cash compensation that is earned and vested, whether or not funded, and whether or not paid under a deferred compensation plan that is qualified under Code Section 401(a);
- the amount of premiums paid for liability or any other insurance coverage or the payment or reimbursement of any penalty, tax or correction owed under the intermediate sanctions rules or certain expenses incurred by an organization resulting from a disqualified person's willful conduct, unless such payments are excludable from income as a *de minimis* fringe benefit under Section 132;
- all other benefits such as medical, dental and life insurance, disability and fringe benefits (other than fringe benefits described in Section 132); and
- any economic benefit provided by an applicable tax-exempt organization itself or indirectly through another entity owned, controlled by or affiliated with the tax-exempt organization.

Note, however, that inclusion of an item in a disqualified person's compensation for purposes of the intermediate sanctions rules does not govern whether the item must be included in the disqualified person's gross income for income tax purposes.

An economic benefit will be treated as compensation for services only if the applicable tax-exempt organization can provide contemporaneous written substantiation of its intent to treat the benefit as compensation when the benefit was paid. Such written substantiation is established by the organization or the disqualified person reporting such economic benefits on applicable federal tax forms (i.e., Forms W-2, 1099, 990, 1040) prior to an IRS examination in which the reporting of the benefit is questioned. If an organization's failure to report a payment was due to reasonable cause, then the organization will be treated as providing clear and convincing evidence of its intent to treat the payment as compensation. Reasonable cause will exist where the organization can establish that there were significant mitigating factors, or that the failure to report arose from events beyond the organization's control and that the organization acted in a responsible manner before and after the failure occurred.

Contemporaneous written substantiation also includes an approved written employment contract or documentation that the governing body or authorized officer approved the payment as compensation for services. The Final Regulations clarify that written evidence upon which the applicable tax-exempt organization based a reasonable belief that a benefit was non-taxable can serve as written contemporaneous evidence demonstrating that a transfer was approved as compensation, even if the organization's belief later proves to be erroneous. Such written evidence must have been in existence on or before the due date of the applicable federal tax information return (including extensions but not amendments). If the organization fails to establish its intent to treat a benefit as compensation for services, any services provided will not be treated as provided in consideration for the economic benefit.

Timing Rules for Determining Reasonableness of Compensation Paid to Disqualified Persons

For purposes of determining whether a payment to a disqualified person is reasonable compensation, reasonableness is determined with respect to any fixed payment (including payments based on a fixed formula, as such term is defined under the initial contract exception discussed above) at the time the parties enter into the contract. For non-fixed payments, reasonableness of compensation is based on all the facts and circumstances, up to and including circumstances as of the date of the payment at issue (because determining the amount of such payment or whether to make such payment requires the exercise of discretion after the contract is executed). The Final Regulations clarify that these general timing rules apply to property subject to a substantial risk of forfeiture. Therefore, if the property is subject to a substantial risk of forfeiture and satisfies the definition of fixed payment, reasonableness is determined at the time the parties enter into the contract providing for the transfer of the property. However, if the property is not a fixed payment, then reasonableness is determined based on all the facts and circumstances, up to and including circumstances as of the date of payment. An example was added to the Final Regulations to illustrate how the regular timing rules for determining reasonableness apply to property that is subject to a substantial risk of forfeiture.

Revenue-sharing Arrangements

The Final Regulations, like the Temporary Regulations, do not provide any guidance on the controversial topic of "revenue-sharing" transactions or arrangements in which compensation is calculated by reference to the exempt organization's revenues. Such arrangements are often entered into between physicians and hospitals, and between educational institutions and technology providers involved in distance learning transactions. The IRS in the Final Regulations continues to leave the revenue-sharing arena reserved for possible future consideration in additional regulations. In the meantime, revenue-sharing arrangements will continue to be subject to the general rules governing excess benefit transactions. As an important gloss on these general rules, Treasury Department officials have previously indicated in public comments that at present there are no "per se" structurally impermissible revenue-sharing arrangements.

Penalty Taxes on Excess Benefit Transactions

Under Code Section 4958, a disqualified person who engages in an excess benefit transaction will be subject to a first-tier penalty excise tax equal to 25 percent of the amount of excess benefit. If the transaction is corrected within the taxable period[14] and the IRS finds that the transaction was due to reasonable cause and not willful neglect, then the 25 percent tax will be abated. If the transaction is not corrected within the taxable period, then the disqualified person will be liable for a second-tier penalty tax of 200 percent of the excess benefit. Furthermore, an organization manager who participates in the excess benefit transaction, knowing that it was such a transaction, is liable for payment of an excise tax equal to 10 percent of the excess benefit (capped at $20,000 per excess benefit transaction), unless the participation was not willful and was due to reasonable cause. If more than one disqualified person or organization manager is liable for any penalty excise taxes, all such persons are jointly and severally liable.

The excise taxes apply to excess benefit transactions occurring on or after September 14, 1995. These taxes do not apply to a transaction pursuant to a written contract that was binding on September 13, 1995 and all times thereafter. A written binding contract that is materially modified or terminable without the disqualified person's consent is treated as a new contract as of the date of such modification or termination.

Correction of the Excess Benefit

Correction of the transaction entails undoing the excess benefit to the extent possible and 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 had been dealing with the highest fiduciary standards. Correction occurs if the disqualified person repays an amount of money equal to the excess benefit, plus any additional amount needed to compensate the organization for loss of the use of the money. Correction may also occur, at the discretion of the applicable tax-exempt organization, if the disqualified person returns property that resulted in an excess benefit and takes any additional steps necessary to make the organization whole.

The Final Regulations require that where a Section 501(c)(3) organization involved in an excess benefit transaction ceases to exist or is no-longer tax-exempt, the correction amount must be paid to a publicly-supported charity that has been in existence as such for a continuous period of at least 60 calendar months ending on the correction date. The disqualified person also must not be a disqualified person with respect to the substituted public charity and must not be allowed to make or recommend any grants or distributions by the substituted public charity. The 60-month existence requirement, according to the IRS, prevents the disqualified person from creating a new organization to receive the correction amount. These requirements (other than the public supported charity requirement) also apply to a substitute Section 501(c)(4) organization receiving the correction amount.

Amount of Excess Benefit

In the case of an unreasonable compensation arrangement, the excess benefit will be the amount by which the compensation exceeds reasonable compensation. In the case of a non-FMV transaction, the excess benefit will be the amount by which the transaction differs from FMV.

Excise Tax on Organization Managers

As noted above, organizational managers who knowingly participate in an excess benefit transaction will be liable for a 10 percent excise tax on the excess benefit up to a maximum of $20,000 per transaction, unless such participation was not willful and was due to reasonable cause. The regulations define organization manager as any officer, director or trustee of an applicable tax-exempt organization or any individual having powers or responsibilities similar to those in such positions, regardless of title. In addition, those persons serving on a committee of the governing body of the organization that is invoking the rebuttable presumption of reasonableness (discussed below) based on the committee's actions is an organizational manager. A person will be considered an officer if so designated in the organizational documents or if that person regularly exercises general authority to make administrative or policy decisions on behalf of the organization (but not including persons who merely have the authority to recommend a particular administrative or policy decision). Independent contractors acting in the capacity of attorneys, accountants or investment managers and advisors are not officers.

Knowing Participation by Organizational Managers

For purposes of the 10 percent excise tax, participation by organization managers includes affirmative action and silence or inaction where the manager is under a duty to speak or act. Where a manager has opposed an excess benefit transaction in a manner consistent with his responsibilities to the organization, the manager will not be considered as having participated in the transaction. Knowing participation in an excess benefit transaction exists only if the manager:

- has actual knowledge of sufficient facts so that, based solely on these facts, the transaction would be an excess benefit transaction;
- is aware that such a transaction may violate federal tax law governing excess benefit transactions; and
- negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the manager is in fact aware that it is such a transaction.

The Temporary Regulations provided a safe harbor in which an organization manager's participation in a transaction would ordinarily not be considered knowing if the manager relies on the fact that the requirements giving rise to the rebuttable presumption of reasonableness, as discussed below, are satisfied with respect to the transaction. The Final Regulations provide that an organizational manager's participation in a transaction is ordinarily not considered knowing if the appropriate authorized body has met the requirements of the rebuttable presumption with respect to the transaction. Failure to satisfy the requirements of this safe harbor, however, does not necessarily mean that the organization manager acted knowingly.

Willful Participation, Reliance on Professional Advice

A manager who knowingly participates in an excess benefit transaction will be fined unless such participation was not willful and was due to reasonable cause. Participation is willful if it is voluntary, conscious and intentional (regardless of whether a tax law avoidance motive exists), but is not willful if the manager does not know that the transaction in which he is participating is an excess benefit transaction. A manager's participation will be due to reasonable cause if the manager exercised his responsibility on behalf of the organization with ordinary business care and prudence. If a manager relies on professional advice (including legal counsel, certified public accountants or independent valuation experts who meet the requirements for qualified appraisers) expressed in a "reasoned written opinion" (addressing the facts and applicable standards), the manager's participation in such transaction ordinarily will not be considered "knowing" or "willful" and ordinarily will be considered "due to reasonable cause."

Rebuttable Presumption that Transaction is Not an Excess Benefit Transaction

In general, payments under a compensation arrangement, a property transfer or any other benefit or privilege between an applicable tax-exempt organization and a disqualified person shall be <u>presumed</u> to be reasonable or at FMV if the following three requirements are met:

- The compensation arrangement or terms of the property transfer are approved by the organization's governing body, committee of the governing body or party authorized by the governing body composed entirely of individuals who do not have a conflict of interest with respect to the arrangement or transaction.

- The governing body, committee thereof or party authorized by the governing body obtained and relied upon appropriate data as to comparability prior to making its determination.
- The governing body, committee thereof or party authorized by the governing body adequately documented the basis for its determination concurrently with making that determination.

Once the presumption is established, the IRS may rebut the presumption with additional information showing that the compensation was not reasonable or that the transfer was not at FMV. Note, however, that failure to establish the rebuttable presumption does not create an inference that the transaction is an excess benefit transaction.

Requirement One: Approval Process

The governing body is the Board of Directors, trustees or equivalent controlling body of the tax-exempt organization. The Board may authorize a committee of the Board members to act on behalf of the Board to the extent permitted by state law. If the organization's controlling documents or state law requires full approval of an arrangement or transaction, then committee approval will not be sufficient. The Board also may authorize other parties to act on its behalf in approving compensation arrangements or property transfers provided it specifies procedures and such delegation is allowed under state law. The preamble to the Final Regulations clarifies that a single individual may constitute a committee of the governing body or a party authorized to act on its behalf if permitted under state law.

As required, each member of the Board, committee of the Board or authorized person establishing the rebuttable presumption may not have a conflict of interest. A person will not have a conflict if the person:

- is not the disqualified person and is not related to any disqualified person participating in or economically benefiting from the compensation arrangement or transaction by a family relationship described in Section 4958 or the proposed regulations;
- is not in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefiting from the compensation arrangement or transaction;
- is not receiving compensation or other payments subject to approval by any disqualified person participating in or economically benefiting from the compensation arrangement or transaction;
- has no material financial interest affected by the compensation arrangement or transaction; and
- does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement or transaction, who in turn has approved or will approve a transaction providing economic benefits to the person.

Requirement Two: Comparability Data

In making a determination as to reasonableness of compensation or FMV, the Board, committee thereof or authorized person must have obtained and relied upon appropriate data as to comparability. Appropriate data includes (but is not limited to) compensation levels paid by similarly situated organizations, <u>both taxable and tax-exempt</u>, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; actual written offers from similar institutions competing for the services of the disqualified person; and independent appraisals of the value of property that the applicable organization intends to purchase from, or sell or provide to, the disqualified person.

The examples illustrating appropriate data for comparability indicate that generic national compensation surveys that lack specificity will be insufficient data where the Board lacks expertise on compensation matters. In contrast, customized surveys prepared by a firm with expertise, which sort data by different variables and are accompanied by a written report, will often suffice as appropriate data.

In addition, there is a special rule for small organizations with annual gross receipts of less than $1 million.[15] These organizations will have appropriate data for comparability if they have data on compensation paid by three comparable organizations in the same or similar communities for similar services. Such information may be compiled through an informal telephone survey and a brief written report to the Board.

Requirement Three: Documentation

For a decision to be documented adequately, the written or electronic records of the Board or committee thereof must specify:

- the terms of the transaction that was approved and the date it was approved;
- the members of the governing body or committee who were present during debate on the transaction or arrangement that was approved and those who voted on it;
- the comparability data obtained and relied upon by the governing body or committee and how the data was obtained; and
- the actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the governing body or committee, but who had a conflict of interest with respect to the transaction or arrangement.

The requirement of concurrent documentation means that records must be prepared by the later of the next meeting of the Board or committee or 60 days after the final Board or committee approval of a particular arrangement or property transfer. Such records must be reviewed and approved by the Board or committee as reasonable, accurate and complete within a reasonable time period thereafter.

When Can the Rebuttable Presumption be Established?

Consistent with the rules discussed above regarding the timing of the reasonableness determination with respect to a particular transaction, the Final Regulations state that an applicable exempt organization can establish a rebuttable presumption of reasonableness with respect to fixed payments (or those calculated pursuant to a fixed formula) at the time the parties enter into the contract. Likewise, under a special rule, the rebuttable presumption of reasonableness can be established for payments made pursuant to a deferred compensation arrangement such as a qualified pension, profit-sharing or stock bonus plan when the parties enter into the contract for services.

In contrast, for non-fixed payments the rebuttable presumption can only be established after discretion is exercised, the exact amount of the payment is determined (or a fixed formula for calculating the payment is specified), and the above-described three requirements for the rebuttable presumption are satisfied. <u>The Final Regulations do, however, include a limited exception for non-fixed payments subject to a cap</u>. Under this exception, the rebuttable presumption can be established for non-fixed payments if:

- prior to approving the contract, the governing body obtains comparability data showing that a fixed payment up to a certain amount would be reasonable compensation;
- the maximum amount payable under the contract including fixed and non-fixed payments does not exceed the reasonable compensation amount; and
- the other requirements for establishing the rebuttable presumption are satisfied.

Note:

To assure compliance with IRS standards of professional practice, Hogan & Hartson, L.L.P., discloses to you that any federal tax advice in this communication was not intended or written to be used, and cannot be used, for the purpose of avoiding federal tax penalties; and, if used to promote, market, or recommend any transaction, investment or matter, the advice was written to support the promotion or marketing of the transaction or matters addressed. Taxpayers should seek advice, based on their particular circumstances, from an independent tax advisor.

Footnotes

1 Prior to the Temporary Regulations, the IRS issued proposed regulations implementing the intermediate sanctions rules in August 1998 (the "Proposed Regulations"). The Temporary Regulations generally clarified and expanded upon the Proposed Regulations, while nonetheless keeping intact the general framework of the intermediate sanctions rules as outlined in the Proposed Regulations.

2 For transactions prior to September 14, 2000, the lookback period begins on September 14, 1995 and ends on the date of the transaction.

3 A foreign organization that receives substantially all of its support from sources outside the United States is not an applicable tax-exempt organization for Section 4958 purposes.

4 A person's family includes his or her spouse; brothers or sisters (by whole or half blood); children; grandchildren; great grandchildren; ancestors; and the spouses of brothers or sisters, children, grandchildren, and great grandchildren.

5 A 35-percent controlled entity is: (a) a corporation in which disqualified persons, as determined otherwise under the regulations, own more than 35 percent of the combined voting power; (b) a partnership in which disqualified persons own more than 35 percent of the profits interest; or (c) a trust or estate in which disqualified persons own more than 35 percent of the beneficial interest. In making these determinations, the constructive ownership rules of Code Section 267(c) apply.

6 Under both the Temporary Regulations and the Final Regulations, a Section 501(c)(3) organization cannot be a disqualified person vis-à-vis another Section 501(c)(3) organization and a Section 501(c)(4) organization cannot be a disqualified person vis-à-vis another Section 501(c)(4) organization. However, a Section 501(c)(4) organization may be treated as a disqualified person with respect to a Section 501(c)(3) organization.

7 As referenced in Code Section 414(q)(1)(B)(i). For 2007, this amount is $100,000.

8 Code Section 507(d)(2) defines substantial contributor as any person who contributes or bequeaths an aggregate amount of more than $5,000 to the organization, if such amount is more than 2 percent of the total contributions and bequests received by the organization taxable year of the organization taking into account the current taxable year and the four preceding taxable years. (See other subsections of 507(d)(2) for special rules and exceptions.)

9 See footnote 8 above.

10 The Final Regulations define fair market value as 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 the property or right to use the property, and both having reasonable knowledge of relevant facts.

11 Amounts payable pursuant to a qualified pension, profit-sharing, or stock bonus plan under Section 401(a), or pursuant to an employee benefit program that is subject to and satisfies coverage and non discrimination rules (e.g., Sections 127 and 137) are treated as fixed payments regardless of the exempt organization's discretion with respect to the plan or program.

12 Control by an applicable exempt organization means (i) ownership (by vote or value) of more than 50 percent of the stock of a corporation; (ii) ownership of more than 50 percent of the profits or capital interest in a partnership; (iii) in the case of a nonstock corporation, 50 percent or more of the directors or trustees of the controlled entity are representatives of, or controlled by, the applicable exempt organization; and (iv) ownership of more than 50 percent of the beneficial interest in any other entity.

13 The preamble to the Final Regulations indicates that the IRS refused to treat lodging furnished for the convenience of the employer as a disregarded economic benefit.

14 The taxable period begins with the day on which the excess benefit transaction occurs and ending on the earlier of (a) the date of mailing a notice of deficiency under Section 6212 with respect to the Section 4958(a)(1) tax (the 25 percent excise tax); or (b) the date on which the tax imposed by Section 4958(a)(1) is assessed.

15 For purposes of determining eligibility for the special rule for small organizations, if a tax-exempt organization is affiliated with another entity by common control or governing documents, the annual gross receipts of all such related organizations must be aggregated.