Background

As part of the Taxpayer Bill of Rights 2 (Pub. Law. 104-168) passed in July 1996, Congress enacted an intermediate sanctions rule imposing penalties on so-called “excess benefit” transactions by certain tax-exempt organizations, primarily Section 501(c)(3) organizations. Congress was reacting to the much publicized problems at the United Way charity; the Internal Revenue Service (IRS) had complained to Congress that in dealing with abuses by Section 501(c)(3) exempt organizations, its authority was limited to either doing nothing or revoking tax exemption. In essence, the IRS argued that it needed an “intermediate sanction” to address such abuses.

While the law covers a variety of transactions, it was primarily intended to curb excessive compensation arrangements for key tax-exempt organization employees. Broadly stated, Section 4958 of the Internal Revenue Code (the “Code”) imposed a tax penalty on “disqualified persons” who improperly benefit from “excess benefit transactions” and on “organization managers” who participated in the transaction knowing that it was improper. Thus, certain individuals connected with Section 501(c)(3) and Section 501(c)(4) organizations are subject to tax penalties, although the organizations themselves are not. On August 4, 1998, the IRS proposed draft regulations to implement the excess benefit law. See 63 Fed. Reg. 41,486 (1998).

More than two years later, on January 10, 2001, the IRS promulgated three-year temporary regulations (“temporary regulations”) in response to comments received on the proposed regulations. See 66 Fed Reg. 2144 (2001) (to be codified at 26 C.F.R. Parts 53, 301, and 602) (January 10, 2001). As with the August proposed regulations, the new rules generally apply to excess benefit transactions occurring on or after September 14, 1995, and the IRS may impose such taxes as an alternative to revocation of exempt status, or as an additional penalty.

On the same date that the IRS issued the new regulations, the IRS issued a notice seeking comment on the temporary regulations (comments are due to the IRS by April 10, 2001), indicating that the IRS intends to continue analyzing the proper treatment of excess benefits. Nonetheless, these “temporary regulations” are effective through at least January 9, 2004, and should guide the compensation determination for all applicable tax-exempt organizations for at least the next three years.

Changes Made to Definitions and Key Elements of Intermediate Sanctions Rule

For the most part, the temporary regulations maintain the basic scope and requirements of the 1998 proposed regulations, but expand and clarify certain sections of the regulations. The following lists some of the more significant changes made to definitions and applicable requirements by the temporary regulations.

A. Excess benefit transactions generally

An “excess benefit transaction” is defined by statute to mean any transaction “in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disquali-
fied person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.” The temporary regulations clarify that the standard of “fair market value” is to be used in making determinations regarding the value of the consideration. However, the temporary regulations have made substantial changes in terms of what constitutes an excess benefit, when an excess benefit transaction occurs, and the like. These changes are summarized below.

- Perhaps most significantly, the temporary regulations have eliminated the language that dealt separately with revenue-sharing transactions – the tying of compensation to the organization’s earnings – despite receiving a great number of comments on the issue. The section of the proposed regulations that once addressed revenue-sharing is now “reserved.” According to the preamble, revenue-sharing benefits are to be treated under the general rules defining excess benefit transactions. As a result, this issue is left largely unresolved under the new rules.

- Similarly, the regulations decline to provide special guidance with regard to donor-advised funds, but the IRS does request comment from the public as to how these funds should be treated.

- The temporary regulations note that an excess benefit can be received either directly or indirectly through a controlled entity or an intermediary. The temporary regulations provide that the determination as to whether an individual has substantial control over an entity or its affiliates is made separately with regard to each applicable tax-exempt organization. This change will be of great importance to Section 501(c)(6) trade associations and professional societies as well as Section 501(c)(3) exempt organizations, since many trade associations have established affiliated charities, foundations, or social welfare corporations under Section 501(c)(3) or Section 501(c)(4). Therefore, any key personnel involved in the operations of both the trade association/professional society and the affiliate, and who may receive compensation from both sources, should take care in establishing compensation arrangements.

- The regulations also clarify that an excess benefit transaction is deemed to occur on the date the individual receives the excess benefit for federal tax purposes. Certain benefits are not subject to these rules, however, such as nontaxable fringe benefits or certain economic benefits paid to volunteers, members, donors, or governmental entities.

- The rules have also been greatly expanded to include an explicit “initial contract exception,” in which fixed payment compensation received under an initial contract will not constitute an excess benefit transaction even if the compensation is later deemed to be an excess benefit. This provision [consistent with the decision on private inurement reached by the courts in United Cancer Council, Inc. v. Comm’r, 165 F.3d 1173 (7th Cir. 1999)] is based on the premise that an individual who is not yet employed by the organization and is negotiating an initial contract cannot yet be a “disqualified person” of the organization subject to the rules. However, the temporary regulations also go into great detail to explain when an “initial” contract has been modified by a “material change,” thereby transforming the contract into one subject to excess benefit rules. The rules in this area are complex and deserving of careful scrutiny.

- The rules clarify the treatment of certain special payment arrangements, such as a compensation obligation that is to be paid in increments rather than in one lump sum (excess benefit occurs on the last day of the taxable year or on the date of the last payment in the series) and deferred compensation such as stock bonus plans, pensions, or profit-sharing (excess benefit occurs on the date benefits
are vested unless disqualified person reported them as taxable income for the year in which they were received).

- In an issue not previously addressed, the preamble to the temporary regulation provides that embezzled funds should be viewed by the organization as excess benefits subject to these rules.

B. Applicable tax-exempt organizations

Generally, the term “applicable tax-exempt organization” under the regulations refers to organizations exempt under Section 501(c)(3) or Section 501(c)(4) of the Code. Certain exceptions are provided in the temporary rules:

- Private foundations are not subject to these rules, but public charities are covered.
- Governmental entities exempt from taxation are not considered applicable tax-exempt organizations subject to these rules.
- Despite much speculation on the part of the association community, the IRS has not added Section 501(c)(6) organizations to the list of organizations subject to the excess benefit rules. In fact, the temporary regulations and preamble discussion do not address the role of Section 501(c)(6) organizations at all except indirectly, through the reference to affiliated organizations as discussed above. As a result, while it would be prudent for Section 501(c)(6) trade and professional organizations to consider the excess benefit rules in establishing compensation, those organizations are not legally bound by the excess benefit rules.

C. Disqualified persons

The term “disqualified person” is defined by the Code to include “any person who was, at any time, during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization,” and such person’s family members. A disqualified person may also be a 35% owned corporation of the organization. A disqualified person found to have engaged in an excess benefit transaction is required to pay a 25% tax on that excess benefit and, if the issue has not been corrected within a certain time frame, an additional 200% tax. The temporary regulations have revised the definitions and requirements of disqualified persons to a certain extent, as follows:

- The temporary regulations have removed the “per se” categories approach to defining disqualified persons by title (director, officer, etc.). Instead, the temporary rules look to the actual powers and responsibilities of the individual involved to determine if he or she was in a position to exercise substantial influence over the organization. “Substantial influence” is to be determined by a facts and circumstances test. For example, the manager of a discrete segment of the organization may well not be a disqualified person, while someone who does not carry the title of director or trustee may nonetheless be exerting influence over the organization so as to be subject to the rules.
- The temporary regulations delete the provision from the proposed regulations which provided that a person having or sharing authority to sign drafts or authorize electronic transfers of funds is automatically considered a “treasurer” or “chief financial officer,” and therefore a likely disqualified person. Again, substantial influence would need to be shown through a facts and circumstances analysis before such an individual would be considered a disqualified person.
- The temporary rules clarify that, while 35% controlled entities may be considered disqualified persons, Section 501(c)(3) organizations are not considered disqualified persons with substantial control over an applicable tax-exempt entity. Further, Section 501(c)(4) organizations are not...
considered to exercise substantial control over other Section 501(c)(4) organizations.

The preamble also clarifies that any disqualified person subject to investigation for excess benefit violations would receive advance notice from the IRS that an examination was being conducted in the form of a “first letter of proposed deficiency,” which allows that individual to appeal the initial findings with the IRS before any penalty would be imposed.

The temporary regulations clarify that independent contractors such as legal counsel and certified public accountants are not deemed to have substantial influence over the organization if the contractor’s sole relationship to the organization is to provide professional advice and the contractor does not have control over the organization’s decisions. This rule presumes that the contractor receives no compensation from the organization other than normal and customary fees.

**D. Organization managers**

An organization manager, who may also be subject to financial penalties, is “any officer, director, or trustee of such organization (or any individual having powers or responsibilities similar to those of officers, directors, or trustees of the organization).” This could include chief staff officers and such organizational managers with knowledge of the transaction. Such individuals are subject personally to a 10% tax on the excess benefit, which may not exceed $10,000. A few important changes made by the temporary regulations should be noted:

- The temporary regulations note that the IRS has the burden of proof in demonstrating that a manager “knowingly” participated in an excess benefit transaction, an issue not addressed in the proposed regulations.

- The 1998 proposed regulations provided a safe harbor for organizational managers who relied on the advice of counsel. The temporary regulations expand this safe harbor significantly to allow organizational managers to rely on the advice of legal counsel (including in-house counsel), certified public accountants and accounting firms with relevant expertise, and “independent valuation experts” who meet certain requirements.

**E. Correction**

Correction of an excess benefit transaction must still be made by a disqualified person in order to avoid an additional 200% tax on the transaction. The temporary regulations reiterate that “correction” involves undoing the excess benefit to the extent necessary to ensure that the tax-exempt organization is no worse off financially than it would have been had the excess benefit transaction not occurred. However, the temporary regulations also significantly expand the discussion of correction, for example:

- The temporary regulations state firmly that disqualified persons cannot choose the form of correction, but must make cash repayment of the excess benefit (unless the transaction involved the transfer of property, in which case the organization can demand either return of the property or cash repayment).

- The regulations provide that the correction amount must equal the sum of the excess benefit plus interest on the excess benefit.

- A disqualified person may correct an excess benefit received in the form of nonqualified deferred compensation benefits that have not yet been distributed by giving up any claim to receive the benefits (including earnings on them).

- If an excess benefit transaction is partially corrected within the 90-day cure period, only that portion of
the benefit that has not been repaid will be subject to the 200% tax.

The temporary regulations allow an organization to amend its tax returns (and the information reported with regard to benefits intended as compensation) at any time prior to the onset of an IRS investigation.

If the tax-exempt organization has ceased to exist at the time the excess benefit is discovered, the correction amount must be made to another Section 501(c)(3) or Section 501(c)(4) organization, as applicable, pursuant to the organization’s dissolution provisions.

**Reasonableness of Compensation Plan**

In order to avoid incurring penalties for excess benefits, an organization must ensure that the compensation package it establishes for a disqualified person is reasonable. The first step in establishing the reasonableness of a compensation plan is ensuring that the economic benefits provided to a disqualified individual are intended to be compensation and are treated properly as such (i.e., are reported on the appropriate tax forms or included as part of an employment agreement).

In order for compensation to be considered reasonable, the intent to treat certain benefits as compensation must be clearly stated *in writing* at the time of the transaction in order to provide contemporaneous substantiation. Interestingly, the temporary regulations have shifted the burden with regard to establishing intent; whereas the 1998 proposed regulations provided that an economic benefit *will be* “intended” as a benefit unless the organization provides clear and convincing evidence to the contrary, the temporary regulations now provide that an economic benefit *is not* treated as consideration for the providing of services unless the organization providing the benefit clearly indicates its intent to treat the benefit as compensation when the benefit is paid.

The temporary regulations still define “compensation” broadly to include all economic benefits provided by an applicable tax-exempt organization in exchange for the performance of services. The regulations provide that such benefits include, but are not limited to: all forms of cash and noncash compensation, including salary; fees; bonuses; severance payments; deferred and noncash compensation as defined by the regulations; payment of liability insurance premiums for (i) penalties, taxes, or expenses of correction under the excess benefit rules, (ii) expenses related to civil proceedings arising out of the person’s performance of services on behalf of the organization, and (iii) expenses related to willful acts or acts without reasonable cause; welfare benefit plans, such as medical, dental, or life insurance benefits; disability benefits; and taxable and nontaxable fringe benefits, including expense allowances or reimbursements and foregone interest on loans. The temporary regulations do provide, however, that insurance premiums paid may be disregarded if they qualify as a de minimis fringe benefit under section 132(a)(4) of the Code.

**The “Rebuttable Presumption of Reasonableness”**

As indicated above, compensation plans must be deemed “reasonable” in order to avoid potential liability for taxes on the excess benefit. The Code does not set forth a test for determining when an economic benefit paid to a disqualified person is “reasonable” and therefore meets the excess benefit test. However, the regulations allow individuals to rely on a “rebuttable presumption of reasonableness” with respect to compensation arrangements if certain criteria are met.

In other words, if the three criteria outlined below are met, the IRS will presume that the compensation plan is reasonable and it will be the IRS’ burden to demonstrate otherwise. Indeed, the temporary regulations make the IRS’ burden slightly greater than before. The 1998 proposed regulations stated that the IRS could rebut the presumption of reasonableness with
“additional information” showing that the compensation was unreasonable; by contrast, the temporary regulations now provide that the IRS may rebut the presumption “only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body.”

The elements of the rebuttable presumption test proposed in 1998 remain essentially the same, although the new regulations add different nuances to the requirements. Under the temporary regulations, the rebuttable presumption will arise with respect to a compensation agreement if the following conditions are satisfied:

1. The compensation arrangement or the terms of the property transfer are approved in advance by an authorized body of the applicable tax-exempt organization (or an entity controlled by the organization) composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement or property transfer.

2. The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination.

3. The authorized body adequately documented the basis for its determination concurrently with making that determination.

The explanation of these elements has been somewhat changed under the new regulations, as follows:

1. Approval by an authorized body
   - Whereas the 1998 regulations required that an organization’s “governing body” make compensation determinations, the temporary regulations have been revised to require an “authorized body” to perform this function. While an authorized body could still be the board of directors, the board of trustees, or a committee, the temporary regulations also provide broadly that an authorized body may mean “other parties authorized by the governing body to act on its behalf” to the extent permitted under state law.

2. Appropriate data as to comparability
   - The temporary regulations require that comparability data be obtained so that, given the knowledge and expertise of the authorized body, that body has sufficient information to determine if “the compensation arrangement in its entirety is reasonable or the property transfer is at fair market value.” Comparability data can take the form of a review of compensation levels paid by similarly situated organizations (both taxable and tax-exempt) for “functionally comparable” positions; a review of the availability of similar services in the same geographic area; current compensation surveys performed by independent firms; actual written offers from similar organizations; independent appraisal of property; or property valuations determined as the result of competitive bidding.

   - The preamble to the regulations takes pains to emphasize that while customized surveys by independent vendors would certainly provide the necessary information, organizations do not have to go to the expense of such surveys so long as appropriate data and sufficient information are available.

   - The temporary regulations provide that in the case of non-fixed payments, the rebuttable presumption with respect to that benefit can only arise after the exact amount of the payment is fixed or a fixed formula for calculating the benefit is established. If the non-fixed payments are subject to a cap (i.e., discretionary bonuses), the rebuttable presumption may be established with respect to that benefit if (i) prior to approving the contract, the authorized body obtains data indicating that the capped amount would be reasonable; (ii) the maximum amount payable under the contract, including fixed and non-fixed compensation, would be reasonable;
and (iii) the other requirements for the rebuttable presumption are met.

- The temporary regulations provide a safe harbor for small organizations. An organization with gross receipts of less than $1 million will be deemed to have appropriate information if it obtains compensation data from three comparable organizations (the 1998 regulations had required five reports).

3. Documentation

- As with the 1998 proposals, proper documentation must include the terms of the transaction and date of approval, the members of the authorized body present during debate and those who voted to approve the compensation package, the comparability data used, and notation of how the body treated an individual with a conflict of interest in the transaction.

- The temporary regulations impose certain time limits for documentation. For a decision to be documented concurrently, records must be prepared before the later of the next meeting of the authorized body or 60 days after the final action(s) of the authorized body are taken. The records must then be reviewed and approved by the authorized body within a “reasonable time” thereafter.

Conclusion

While there is still opportunity for future revision of the temporary regulations, these regulations are effective for at least the next three years. The rebuttable presumption test remains almost identical, and Section 501(c)(3) and Section 501(c)(4) organizations are encouraged to follow the IRS’ criteria for the presumption, especially since the temporary regulations appear to make rebutting the presumption a bit more difficult for the IRS. While it would be advisable for all affected tax-exempt organizations to apply the rebuttable presumption test when developing a compensation plan, it should be noted that even if an organization does not follow these steps, the organization will not necessarily be deemed to have engaged in an excess benefit transaction. However, meeting these criteria ensures, to the greatest extent possible, that a compensation package will be considered reasonable.

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