

Client Alert

A report
for clients
and friends
of the firm

September 2001

Intermediate Sanctions Temporary Regulations

Recently, the IRS issued temporary and proposed regulations (the "Regulations") imposing penalties on certain insiders who engage in excess benefit transactions as well as on the executives of an organization who approve these transactions.

An "excess benefit transaction" is a transaction in which a Section 501(c)(3) public charity (not a private foundation) or a Section 501(c)(4) civic league, social welfare organization or charitable local association of employees provides an economic benefit to an insider that has a greater value than what the organization receives in return, in property and services.

The penalties can be severe. An insider can be required to pay a 25% excise tax on the amount of an excess benefit; indeed, if the 25% tax is imposed and the transaction is not corrected within a specified time period, the government can impose an additional 200% tax. An executive or director of an organization who knowingly and willfully participated, without reasonable cause, in an excess benefit transaction can face a 10% tax, up to \$10,000 per transaction. Moreover, an executive who also engaged in the transaction as an insider may be liable for all three excise taxes.

Excess Benefit Transaction

The Regulations provide examples of "excess benefit transactions" and define the insiders (known as "disqualified persons") and the executives (referred to as "organization managers") to whom the Regulations apply.

The amount of excess benefit on which the tax is imposed is equal to the difference between the benefit provided to the insider less the value of the services provided by the insider and the value of any property exchanged by the insider.

One example of an excess benefit transaction is an organization providing too much compensation to its president as compared to the services rendered by the president. Thus, if the organization pays \$200,000 for its president's services which are worth \$150,000, the excess benefit would be \$50,000. Another example of an excess benefit transaction is an organization purchasing (or renting) property from its treasurer for more than the property's sale (or rental) value.

Importantly, the following economic benefits to disqualified persons are disregarded for purposes of determining whether an excess benefit transaction has occurred:

- nontaxable fringe benefits;
- a benefit provided to an organization's volunteer, where the benefit is provided to the public for a membership fee or a contribution of \$75 or less;
- a benefit provided to an organization's members in exchange for their membership fee, or to its donors on account of their contributions, only if the same economic benefit is available to non-disqualified persons making a comparable contribution or membership payment and both a disqualified person and a significant number of non-disqualified persons make the specified contribution or payment;
- a benefit provided to a disqualified person who belongs to the charitable class benefitted by the organization; and
- any transfer of an economic benefit to or for the use of a governmental unit, if benefit used exclusively for public purposes.

Additionally, fixed payments made to persons pursuant to an initial contract are not included in the determination of whether an excess benefit transaction has occurred.

A fixed payment means an amount of cash or other property specified in a contract, or determined by a fixed formula specified in a contract, which is to be paid or transferred in exchange for the provision of specified services or property. A fixed formula can depend upon future specified events or contingencies (including the amount of revenues generated by a specific activity) however it may not include any individual's discretion when determining the amount of a payment or whether a payment will be made. Similarly, a fixed payment does not include a reimbursement where discretion is exercised as to the amount of expenses incurred or reimbursed. Nevertheless, amounts payable pursuant to a qualified pension, profit-sharing or stock bonus plan are fixed payments for these purposes, as are amounts payable pursuant to an employee benefit plan that meets the coverage and nondiscrimination rules of the Internal Revenue Code.

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 the contract.

It should be noted that if the person fails to substantially perform his obligations under the initial contract during any taxable year, then any fixed payments made within that year will be included in the determination of whether an excess benefit transaction has occurred.

Disqualified Person

A "disqualified person" is a person (and certain relatives) who, at any time during the five years preceding the excess benefit transaction, was in a position to exercise "substantial influence" over the organization. The related parties that also are disqualified persons are spouses; siblings and their spouses; ancestors; children, grandchildren and great grandchildren and their spouses; and entities in which the disqualified person has more than a 35% interest.

Disqualified persons include:

- voting members of the organization's governing body;
- the president, chief executive officer, chief operating officer, treasurer, or chief financial officer of the organization. Regardless of actual title, this category includes any person who has the ultimate responsibility for supervising the management, administration or operation of the organization; implementing the decisions of the governing body or managing the finances of the organization; and
- any person who has a material financial interest in certain provider-sponsored organizations, including a provider-sponsored organization in which a tax-exempt hospital participates.

Disqualified persons do not include:

- Section 501(c)(4) organizations with respect to transactions engaged in with other Section 501(c)(4) organizations;
- public charities themselves; and
- employees receiving less than \$85,000 per year (for 2001) who are not substantial contributors and who are not otherwise disqualified persons (including their relatives).

Facts And Circumstances Test

There is a "facts and circumstances" test to determine whether a person who is not described in a category above would still be a disqualified person. Facts and circumstances that show substantial influence include whether the person:

- founded the organization;
- is a substantial contributor;
- is compensated based on revenues derived from activities of the organization that the person controls;
- has authority to control or determine a significant portion of the organization's capital expenditures, operating budget, or compensation for employees;
- has managerial authority over a discrete segment of the organization that represents a substantial portion of the organization's assets, activities, income or expenses, compared to the organization as a whole;
- owns a controlling interest in an entity that is a disqualified person; and

- is a non-stock organization controlled, directly or indirectly, by one or more disqualified persons.

Facts and circumstances that tend to show no substantial influence include whether the person:

- has taken a bona fide vow of poverty;
- has a direct supervisor who is not a disqualified person;
- does not participate in the management of the organization as a whole or over a discrete segment of the organization that represents a substantial portion of the organization's assets, activities, income or expenses, compared to the organization as a whole;
- is an independent contractor, *e.g.*, an attorney, accountant, or investment manager, who would not benefit from a transaction, except for professional fees; and
- is a donor who receives no more preferential treatment than other donors making comparable contributions as part of a solicitation intended to attract a substantial number of contributions.

Applying The Facts And Circumstances Test

Suppose an artist earns \$30,000 working at a museum, is not related to any disqualified person, and enjoys free admission, a benefit that is provided to all employees and volunteers, then the artist is not a "disqualified person."

If, however, the museum purchases a painting from the artist for more than \$80,000, it would be necessary to examine the facts and circumstances to determine whether he exercises substantial influence.

Now consider a bingo managing company that operates a bingo parlor for an organization once a week in exchange for retaining 70% of the revenue generated, which is more than half of the organization's total revenue. The company and its owner are disqualified persons because the company's compensation is based on revenues from activities it controls and it has full managerial authority over the organization's principal source of income.

Another situation might involve a cardiologist who is the head of a hospital's cardiology department, which is an important source of patients for the hospital. If the cardiologist has managerial authority over the department as well as the authority to allocate the budget for the department, including the allocation of incentive bonuses, the cardiologist is a disqualified person. By contrast, a radiologist who has no managerial authority over any part of the hospital or its operations and who does not serve as a supervisor to other hospital employees is not a disqualified person.

Organization Manager

One of the important issues the IRS sought to address with these Regulations is the compensation payable to disqualified persons, including an organization's senior executives.

Compensation is reasonable -- and not considered an "excess benefit" -- if it is an amount ordinarily paid by similar enterprises for similar services in similar situations, generally based on circumstances existing at the time the organization and the disqualified person enter into an employment contract. It is important to

note that the Regulations state that a compensation package is not necessarily reasonable simply because a government body or a court approves it.

Compensation includes all amounts earned, including:

- salary;
- fees;
- bonuses;
- severance payments;
- deferred compensation that is earned and vested, whether paid under a tax-qualified plan or not;
- insurance premiums paid and reimbursements for expenses not covered by insurance;
- all other taxable and nontaxable benefits (other than working condition or de minimus fringe benefits) such as medical, dental, life insurance, and disability benefits; and
- any economic benefit provided directly or indirectly through an affiliated organization.

An organization must clearly indicate its intention to treat an economic benefit as compensation; otherwise, the benefit would be considered an excess benefit. An organization clearly indicates its intention to treat a benefit as compensation by filing a Form W-2 or Form 1099, or by reporting the payment of such benefit on its Form 990 Information Return before the start of an IRS examination. Alternatively, the disqualified person may report the benefit on his or her Form 1040 tax return. There are certain exceptions if an organization fails to report the benefit as compensation, provided that the organization can establish significant mitigating factors for its failure to report.

Rebuttable Presumption of Reasonableness: Three Requirements

The Regulations provide that a compensation agreement will be presumed to be reasonable and a property sale (or rental) agreement will be presumed at fair market value if three requirements are met: (1) approval by the governing body, (2) reliance on comparability data; and (3) adequate documentation of the basis for approval.

Board Approval

The first requirement is that the agreement is approved by the governing body of the organization, or another party authorized to act on the body's behalf, composed entirely of individuals who do not have a conflict of interest with respect to the agreement.

A board or committee member will not have a conflict of interest if the member:

- is not (or is not related to) the disqualified person benefitting from the transaction;
- is not an employee subject to any such disqualified person's control;
- does not obtain compensation or other payments subject to the disqualified person's approval;

- has no material financial interest affected by the transaction; and
- will not receive any economic benefit from another transaction that must be approved by the disqualified person.

Comparability Data

The second requirement is that the board or its committee obtain and rely on appropriate comparability data before approval.

The comparability data is appropriate if the board or committee members, given their level of knowledge and expertise, have sufficient information to determine whether the compensation is reasonable or the property transaction is at fair market value. Relevant information includes:

- compensation levels paid by similarly-situated taxable and tax-exempt organizations for comparable positions;
- the availability of similar services in the geographic area of the organization;
- independent compensation surveys compiled by independent firms;
- actual written offers from similar institutions competing for the disqualified person's services; and
- independent appraisals of the value of the property to be purchased or sold.

Consider, for example, a large, tax-exempt university with \$200 million of revenue per year that is determining its president's compensation. Suppose that the executive committee of the university's board of trustees has members with significant business experience but no expertise in higher education compensation matters. Under these circumstances, the university would not satisfy the comparability data requirement if the executive committee relies on a national survey of compensation for university presidents that does not divide its data by any measure of university size or other criteria.

On the other hand, consider a tax-exempt hospital with \$250 million of revenue per year that is renewing its chief executive officer's and chief financial officer's contracts. The hospital would satisfy the comparability data requirement if, prior to renewal, the governing board takes the following steps. First, it asks an independent firm specializing in consulting on issues related to executive placement and compensation to prepare a customized compensation survey that covers executives with comparable responsibilities at a significant number of hospitals. Second, the survey data are sorted by a number of different variables including hospital size, nature of hospital services provided, level of experience, and specific responsibilities of executives and compensation packages. Third, the board members are provided with the survey results and a detailed written analysis comparing the hospital's executives to those covered in the survey. Fourth, the board members are able to ask questions of the independent survey firm.

It should be noted that there is a special safe harbor for the comparability data requirement for organizations with annual revenue of less than \$1 million. A board or its committee will satisfy the comparability data requirement by obtaining data on compensa-

tion paid by three comparable organizations in the same or similar communities for similar services.

Adequate Documentation

The third requirement for the rebuttable presumption of reasonableness is that the board or its committee adequately document the basis for its approval when the decision is made.

A decision is adequately documented if the written or electronic records note:

- the terms and the date of the approved transaction;
- the members of the board or its committee who were present during the debate on the transaction and those who voted on it;
- the comparability data obtained and relied on by the board or its committee and how such data was obtained; and
- the actions taken with respect to any member of the board or its committee who had a conflict of interest.

If a board of directors or its committee determines that reasonable compensation for a specific arrangement or fair market value in a specific transaction is higher or lower than the range of comparability data obtained, the board or its committee must record the basis for its determination. The records must be prepared by the next board or committee meeting and must be reviewed and approved by the board or committee as reasonable, accurate, and complete within a reasonable time period thereafter.

If the reasonableness of the compensation cannot be determined based on circumstances existing when a contract for services is made, the rebuttable presumption cannot arise until circumstances exist so that the reasonableness of compensation can be determined.

It should be noted that the IRS may rebut the presumption of reasonableness with additional information showing that the compensation was not reasonable or that the property transfer was not at fair market value. However, even if the requirements for the presumption are not met, the IRS may not simply infer that a transaction is an excess benefit transaction.

Moreover, although state law determines who may serve on a board committee, a committee member who is not a board member will be considered an organization manager subject to the 10% tax if the committee uses the presumption for a transaction and the IRS successfully rebuts the presumption.

Revenue-Sharing Transactions

The Regulations reserve a separate section for revenue-sharing transactions but do not provide specific guidance on the subject.

The previous set of proposed regulations in this area applied a facts and circumstance test to transactions in which a disqualified person obtains an economic benefit that is determined completely or partially by the revenues of one or more activities of the organization. They also stated that a revenue-sharing transaction may be considered an excess benefit transaction even if the economic benefit provided does not exceed the fair market value of the services provided.

You can also visit our Website at www.proskauer.com

A Final Note

In light of these Regulations, organizations should review their compensation packages and other transactions entered into after September 13, 1995 (the date after which these Regulations generally apply) to ensure that the transactions are reasonable or at fair market value and that there is adequate documentation for meeting the rebuttable presumption.

In addition, each organization should verify that it properly reports all economic benefits provided to disqualified persons on a Form W-2 or Form 1099. Organizations also may want to review all revenue-sharing transactions to ensure that such transactions would not be considered excess benefit transactions.

It is important to keep in mind that although the penalties provided in the Regulations allow the IRS to penalize insider deals without revoking an organization's tax-exempt status, they do not replace the old rules. If there is private inurement, *i.e.*, if the organization is not operated exclusively for tax-exempt purposes, the IRS still may revoke the organization's exemption.

NEW YORK LOS ANGELES
WASHINGTON BOCA RATON
NEWARK PARIS

Client Alert

Proskauer's Tax Department includes over 25 attorneys with significant and diverse tax, executive compensation and employee benefits law experience. The following individuals serve as contact persons and would welcome any questions you might have:

Jacob I. Friedman
212.969.3805 — jfriedman@proskauer.com

Stuart L. Rosow
212.969.3150 — srosow@proskauer.com

Matthew Sabloff
212.969.3126 — msabloff@proskauer.com

You may also contact any other member of Proskauer's Tax Department in:

New York	212.969.3000
Washington	202.416.6800
Boca Raton	561.241.7400
Los Angeles	310.557.2900
Newark	973.274.3200
Paris	331.53.05.60.00

Proskauer is an international law firm with more than 550 attorneys who handle a full spectrum of legal issues worldwide.

This publication is a service to our clients and friends. It is designed only to give general information on the developments actually covered. It is not intended to be a comprehensive summary of recent developments in the law, treat exhaustively the subjects covered, provide legal advice or render a legal opinion.

© 2001 PROSKAUER ROSE LLP. All rights reserved.