Honigman Miller Schwartz and Cohn LLP
2001 Health Law Update: TBOR2/Intermediate Sanctions

By Gerald M. Griffith[1]

Introduction

On January 10, 2001, the IRS released temporary regulations relating to the excise taxes on the excess benefit provisions of Section 4958 of the Code,[2] which provisions were enacted in 1996 as part of the Taxpayer Bill of Rights 2 ("TBOR2").[3] The temporary regulations are effective as of January 10, 2001 and will cease to apply January 9, 2004.[4] While the IRS addressed and clarified many of the open questions raised by the proposed regulations released by the IRS on August 4, 1998[5] several key questions remain unanswered. (The IRS simultaneously issued the temporary regulations as proposed regulations with a comment period running through April 10, 2001.)

The temporary regulations generally provide additional flexibility, constructive guidance and helpful examples for tax-exempt organizations, including clarification of the procedures for establishing a rebuttable presumption of fair market value and who will be considered a disqualified person under Section 4958. The IRS continues to place a premium on adequate documentation for, and a reasonable approach to, transactions. The IRS also has included a number of new and revised examples in the temporary regulations to assist organizations in their tax planning. Because of their currency and significant detail, the temporary regulations as a whole should be carefully incorporated into an organization's planning for any transaction with insiders (referred to in TBOR2 as "disqualified persons"). Although some enforcement activities have begun already (e.g., Bishop's Estate, Sta-home Home Health), issuance of the new regulations also may increase the likelihood of active enforcement by the IRS.[6]

Overview of TBOR2

Applicable Organizations. TBOR2 imposes a penalty excise tax on any excess benefit transaction ("EBT") between disqualified persons and any organization described in Sections

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[2] 66 Fed. Reg. 2144 (Jan. 10, 2001). All section references are to the Internal Revenue Code of 1986, as amended, and the TBOR2 regulations unless otherwise noted.

[3] For a detailed discussion of TBOR2 and the related legislative history, see G. Griffith, "Impact of the Taxpayer Bill of Rights 2 on Exempt Organizations," 74 *TAXES:* The Tax Magazine (CCH) 467 (Aug. 1996).

[4] Temp. Reg. §53.4958-8T(c).

[5] 63 Fed. Reg. 41486 (Aug. 4, 1998); G. Griffith, "Proposed TBOR2 Regulations: Guidance on the Eve of Enforcement," 7 Health Law Reporter (BNA) 1558 (Oct. 1, 1998).

[6] See G. Griffith, "What the IRS Is Examining in CEP Audits of Health Care Organizations," 11 Journal of Taxation of Exempt Organizations 201, 204-07 (March/April 2000).

501(c)(3) or (4) of the Code (other than private foundations), or that were so described within the past five years prior to the transaction. Governmental organizations that qualify under Section 115 are not subject to the notice requirements of Section 508 in order to be recognized as exempt under Section 115.[7] The temporary regulations are somewhat unclear on whether governmental hospitals exempt under Section 115 will be covered by TBOR2 if they also applied for exemption under Section 501(c)(3) through filing an exemption application (Form 1023) as provided for in Section 508 of the Code.[8] Some IRS officials have informally commented that the intent was to exempt all Section 115 organizations, even if they also have 501(c)(3) status.

Types of Excess Benefit. A taxable EBT is any non-fair market value transaction where an applicable tax-exempt organization provides an economic benefit (virtually anything of value, including compensation, loans, guaranties, property, use of property, gifts, payment of personal expenses, free or discounted benefits, etc.) directly or indirectly (such as through an affiliate) to or for the use of any disqualified person.[9] The amount of the excess benefit is the differential from fair market value.[10] (A second type of excess benefit consists of revenue sharing arrangements resulting in prohibited private inurement, with the amount of the excess benefit being the amount of the revenue sharing payment that is prohibited. The revenue sharing prohibition, however, is not effective until addressed in final regulations and the temporary regulations reserved this section for further consideration.)

Persons Subject to Tax. The tax is imposed on disqualified persons receiving the excess benefit, with a two-tier tax rate. The first-tier tax is 25% of the amount of the excess benefit. If the transaction is not corrected before the 25% tax is assessed, or within 90 days of the mailing of the deficiency notice for that tax under Section 6212 of the Code, a second-tier tax of 200% of the excess benefit applies. All disqualified persons receiving an excess benefit are jointly and severally liable for the tax as to that EBT. A disqualified person is anyone (individual or entity) in a position to exercise substantial influence over the affairs of the exempt organization, even if that power is not actually used. The term "disqualified person" also includes any such individual's family members and their 35% controlled entities.

In addition, organization managers who participate knowingly and willfully in the transaction without reasonable cause to believe it is not an EBT are taxed at a rate of 10% of the excess benefit. All organization managers are jointly and severally liable for the tax if their participation in the transaction was knowing, willful and without reasonable cause. Liability of organization managers, however, is capped at $10,000 "per transaction." There is no cap on the tax liability for disqualified persons.

Reporting Requirements. Penalty excise taxes under Section 4958 are self-assessing. Disqualified persons and organization managers subject to the tax must pay the tax and file a

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[7] See, e.g., LTR 8012030 (Dec. 27, 1979); LTR 9439008 (June 30, 1994). General counsel memoranda, private letter rulings, technical advice memoranda, exemption rulings and CPE Texts are not precedential authority but are often viewed as indicative of IRS views on an issue absent more definitive guidance.

[8] Temp. Reg. §53.4958-2T(a)(1) & (2); 66 Fed. Reg. at 2147 & 2159.

[9] Temp. Reg. §53.4958-4T(a)(1).

[10] Temp. Reg. §53.4958-4T(b).

return on Form 4720 annually (due May 15 for individuals and other calendar year taxpayers).[11] In addition, for all taxable years beginning on or after July 31, 1996, the exempt organization is required to report the details of all EBTs on its Form 990 for the year.[12]

Revocation of Exemption. Although the exempt organization itself is not subject to the penalty excise tax, the temporary regulations make it clear that tax-exempt status can still be revoked as a result of EBTs.[13] The legislative history of TBOR2 indicates Congressional intent that the penalty excise taxes under Section 4958 generally will be the only sanction for EBTs, and that exemption ordinarily would not be revoked unless the excess benefit rises to such a level that it calls into question whether or not the organization as a whole is operated for charitable purposes.[14] The temporary regulations do not address the level of excess benefit necessary to warrant revocation; however, in the preamble the IRS notes that it intends to apply a facts and circumstances test and that it will publish guidance concerning the factors it will consider in exercising its discretion as it gains more experience in administering Section 4958.[15]

Based on the commentary in the preamble to the proposed regulations (as reiterated in the preamble to the temporary regulations), the IRS intends to consider at least the following "factors relating to the organization's general pattern of compliance with" both the requirements of Sections 501(c)(3) and (4), as applicable, and other federal and state laws: "[1] whether the organization has been involved in repeated excess benefit transactions; [2] the size and scope of the excess benefit transaction; [3] whether, after concluding that it has been party to an excess benefit transaction, the organization has implemented safeguards to prevent future recurrences; and [4] whether there was compliance with other applicable laws."[16] The continuing threat to exemption highlights not only the need for advance approval and documentation of fair market value in transactions with disqualified persons, but also the need for corrective action if excess benefits occur.

Disqualified Persons

Definition. The temporary regulations clarify the bright-line test and the facts and circumstances test to determine who is a disqualified person by virtue of being in a position to exercise substantial influence over the affairs of an exempt organization.[17] Family members and 35% controlled entities continue to be deemed disqualified persons by statute. Once someone is a disqualified person by being in a position to exercise substantial influence, that person continues to be a disqualified person for five years after the ability to exercise substantial influence ends (as do their family members and 35% controlled entities).[18] Family members would include spouse, brothers and sisters (by the whole or half blood), spouses of brothers and sisters (by the

[11] Treas. Reg. §53.6071-1(f)(1).

[12] Code §6033(b)(11); Form 990 (2000), Q. 89.b.-d.

[13] 66 Fed. Reg. at 2155; Temp. Reg. §53.4958-8T(a).

[14] H.R. 104-506 at nn. 12 & 15.

[15] 66 Fed. Reg. at 2155.

[16] 66 Fed. Reg. at 2155.

[17] Temp. Reg. §53.4958-3T(a) & (e).

[18] Temp. Reg. §53.4958-3T(a).

whole or half blood), ancestors, children, grandchildren, great-grandchildren and spouses of children, grandchildren and great-grandchildren.[19] The term "35% controlled entities" would include (following the constructive ownership rules of Section 267(c) but with the TBOR2 definition of family members) a corporation in which a disqualified person owns more than 35% of the combined voting power, a partnership in which a disqualified person owns more than 35% of the profits interest or a trust or estate in which a disqualified person owns more than 35% of the beneficial interest.[20] (Although the term "disqualified person" is generally regarded as synonymous with an "insider" subject to the inurement prohibition, the temporary regulations are silent on whether the IRS will apply the same definition in both cases.)

Deemed Disqualified Persons. Under the bright-line test in the temporary regulations, the following individuals would be deemed conclusively to be disqualified persons in a position to exercise substantial influence over the affairs of the organization: (1) voting members of the governing board; (2) president, CEO, COO and other persons with the power or responsibility, in whole or in part, for implementing decisions of the board; (3) treasurer, CFO and other persons with similar powers or responsibilities; and (4) anyone with "a material financial interest in a provider-sponsored organization" in which the tax-exempt hospital participates (also treated as an insider under Section 501(o) of the Code).[21] The temporary regulations now require that a person must have the actual powers, responsibilities or interests associated with such positions, and not just the title or formal position. Pursuant to comments on the proposed regulations received by the IRS, the temporary regulations no longer treat as disqualified persons those person having or sharing authority to sign drafts or authorize electronic transfer of funds.[22]

Safe Harbor. The temporary regulations include a safe harbor, by providing that the following persons will be deemed not to be in a position to exercise substantial influence: (1) any 501(c)(3) or, as to other 501(c)(4) organizations only, any 501(c)(4) organization subject to TBOR2 (the IRS rejected a requested exclusion for Section 115 governmental entities); and (2) any person (individual or entity) who is paid less than a "highly compensated employee" as described in Section 414(q)(1)(B)(i) of the Code (i.e., $80,000 annually plus a cost of living adjustment pursuant to Section 415(d) or, if elected by the employer, the top 20% of employees in compensation excluding certain new hires, part-time and unionized employees). To qualify for the safe harbor, such a person also must not be (a) a family member or 35% controlled entity of a disqualified person, (b) one of the four categories of individuals above who are deemed to be disqualified persons, or (c) a substantial contributor to the organization as defined in Section 507(d)(2) (higher of $5,000 or 2% of total annual contributions).[23] Examples in the temporary regulations suggest that receipt of benefits of a type and amount provided to all employees and volunteers of an organization will not disqualify an employee from the safe harbor; however, payments outside of the employment relationship (e.g., purchasing a painting) may cause the employee to exceed the Section 414 threshold and lose safe harbor protection.[24]

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[19] Temp. Reg. §53.4958-3T(b)(1).

[20] Temp. Reg. §53.4958-3T(b)(2).

[21] 66 Fed. Reg. at 2147; Temp. Reg. §53.4958-3T(c)(1)-(4).

[22] 66 Fed. Reg. at 2147.

[23] Temp. Reg. §53.4958-3T(d); 66 Fed. Reg. at 2148.

[24] Temp. Reg. §53.4958-3T(g), *Examples 1-2*.

The non-highly compensated person exception should be particularly helpful in narrowing the scope of contracts that should be run through a rebuttable presumption review procedure. It also may protect many medical directors if one Treasury Department official's statement is correct that part-time employees' compensation will not be grossed up to a full-time rate for purposes of applying the $80,000 threshold.[25]

Facts and Circumstances Test. In all other cases, a facts and circumstances test applies, and the factors are illustrated by thirteen examples, including four new examples published in the temporary regulations. With respect to managerial authority, the factors tending to show that a person has substantial influence over the affairs of the organization have been revised to include management authority over a discrete segment or activity of the organization that represents a significant portion of the activities, assets, income or expenses of the organization as a whole. The temporary regulations also eliminate as a factor tending to show that a person has substantial influence the fact that a person serves as a key advisor to a manager. Accordingly, the temporary regulations now include the following factors as indicators that someone may be in a position to exercise substantial influence: (1) founder of the organization; (2) substantial contributor under Section 507(d)(2) ($5,000/ 2% of total contributions during the current taxable year and the four preceding taxable years); (3) compensation is primarily based on revenues derived from activities of the organization he/she/it controls; (4) authority to control or determine a substantial portion of the organization's capital expenditures, operating budget or employee compensation; (5) manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income or expenses of the organization; and (6) owning a controlling interest in a corporation, partnership or trust that is a disqualified person.[26] "Controlling" is not defined for this purpose and the only example given reflects 100% ownership.[27] The term could refer to the same 35% test as applied to treat as disqualified persons entities controlled by an individual disqualified person, to a higher percentage threshold or perhaps even a facts and circumstances test based on factors such as use of proxies, being a board member or managing partner, etc. These factors still could sweep in a large number of health care executives and consultants.

Factors that suggest someone is not a disqualified person include: (1) taking a bona fide vow of poverty as an employee, agent or on behalf of a religious organization; (2) independent contractor serving in the capacity of attorney, accountant, or investment manager or advisor, (unless the person could economically benefit directly or indirectly from the transaction other than by payment of fees for professional services rendered); (3) the direct supervisor of the person is not a disqualified person; (4) the person does not participate in any management decisions affecting the organization as a whole or a substantial, discrete segment or activity of the organization; and (5) receiving only the same preferential treatment as is offered to all donors making comparable contributions as part of a fundraising campaign designed to attract a substantial number of contributions.[28]

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25 See C. Wright, "ABA Tax Section Meeting: Treasury Officials Discuss New Intermediate Sanctions Regs," Tax Notes Today, 98 TNT 148-7 (Aug. 3, 1998).

26 Temp. Reg. §53.4958-3T(e)(2)(i)-(vii).

27 Temp. Reg. §53.4958-3T(f), *Example 6*.

28 Temp. Reg. §53.4958-3T(e)(3). Factors (3) and (4) are new.

Department Heads. The preamble to the temporary regulations also indicates that someone "who has managerial control over a discrete segment of an organization may nonetheless be in a position to exercise substantial influence over the affairs of the entire organization."[29] That interpretation is supported in four examples, where the IRS described two department heads (cardiologist and a law school dean) who are in a position to exercise substantial influence and another two department heads (radiologist and university department chair) who are not.[30]

These are fact specific examples and not a bright-line rule for all heads of cardiology or radiology departments. Accordingly, although we can discern a totality of "key factors" in each example, changing one or more factors alone may (or may not) change the result. Key factors in the law school dean example were: (1) importance of law school as major revenue source with a favorable academic reputation that attracts students and donations; and (2) dean's managerial control over the law school through a key role in faculty hiring and authority to determine a significant portion of its capital and operating budgets. In the cardiologist example, key factors showing substantial influence were (1) managerial authority for the department, such as authority to allocate the departmental budget including allocating incentive bonuses among cardiologists according to criteria he has authority to set; (2) incentive bonus pool funded by a portion of hospital revenues attributable to the department; (3) the department is a principal source of hospital admissions and thus a major revenue source for the hospital. Key factors leading the IRS to conclude that the head of a hospital radiology department was not a disqualified person were: (1) the radiologist's compensation consisted primarily of a fixed salary with no significant revenue-based compensation related to activities he/she controls (though the radiologist was eligible to receive an incentive award based on revenues of the radiology department); (2) no participation in management of any substantial, discrete portion of the hospital's activities, assets, income or expenses (the IRS deleted references to lack of authority over any significant portion of the capital and operating budget or employee compensation); and (3) no managerial authority over employees (supervision limited to provision of medical services). In the university department chair example, the chair supervised department faculty, approved course curriculum and oversaw the department's operating budget. The IRS relied on the following factors to conclude the chair was not a disqualified person: (1) the department did not represent a substantial portion of the university's activities, assets, income, expenses or operating budget; and (2) no participation in management decisions affecting the university or any substantial, discrete portion of the university's activities, assets, income or expenses.

Physicians. Historically, the IRS' bias was toward finding all staff physicians to be insiders.[31] In the legislative history of TBOR2, Congress rejected that sweeping presumption and indicated that only physicians in a position to exercise substantial influence should be treated as disqualified persons.[32] The examples are helpful in illustrating that not all physicians are

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29 66 Fed. Reg. at 2148.

30 Temp. Reg. §53.4958-3T(f), *Examples 8-11*.

31 See, e.g., GCM 39498 (Jan. 18, 1986); GCM 39670 (June 17, 1987); TAM 9451001 (April 14, 1994) (appeal voluntarily dismissed in LAC Facilities v Commissioner, No. 94-604T (Ct. Cl. 1998)).

32 H.R. 104-506 at n. 12.

disqualified persons; however, the range of which physicians are disqualified persons is still potentially very broad. Although the focus in the cardiology and radiology examples is on managerial authority, it is also interesting to note that a radiologist is less likely to be in a position to refer patients to a hospital whereas the cardiology department was a principal source of admissions. Likewise, in the two academic examples, the university department chair was not a disqualified person in part because his/her department did not generate substantial income for the university. Accordingly, the door remains open for the IRS to argue that the volume or value of patient referrals can be reflective of the ability to exercise substantial influence over a hospital. In that regard, one IRS official noted that although physicians are not always disqualified persons, it remains to be seen whether physicians employed by a wholly owned clinic would be disqualified persons under a facts and circumstances test due to their level of economic control.[33]

In addition, the temporary regulations would consider revenue-based compensation as one factor indicating that the recipient is a disqualified person.[34] Given the IRS' historical bias in treating all staff physicians as insiders and its suspicion of revenue-sharing arrangements at least since GCM 39862, the result may be that any physician with a revenue-based incentive compensation arrangement, even one limited to personal productivity, is a disqualified person.

Free "First Bite" and the Initial Contract Exception. On appeal, the Seventh Circuit in *United Cancer Council* declined to treat a fundraiser as an insider for its initial contract where it had no prior relationship with the charity.[35] In the wake of that decision, the temporary regulations modify the IRS' former view (from the proposed regulations) of no free "first bite" at the apple by including an exception for certain initial contracts. Under this exception, Section 4958 would not apply to any fixed payment made to a person pursuant to an initial contract (i.e., a binding written contract between an exempt organization and a person who has no prior relationship to the organization that would make the person a "disqualified person"). Even if the exception applies, however, the other party may be an insider for inurement purposes.[36]

A fixed payment includes cash or other property of an amount specified in the contract, or determined by a fixed formula specified in the contract, which is paid or transferred in exchange for the provision of specified services or property. Fixed payments do not include any expense reimbursement arrangement where any person exercises discretion as to the amount of expenses incurred or reimbursed. A fixed formula may, however, incorporate an amount that depends upon future specified events or contingencies (including the amount of revenues generated by or another objective measure of one or more activities of the exempt organization), as long as nobody can exercise discretion when calculating the amount of the payment or

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33 "Exempt Organizations: IRS Official Discusses Intermediate Sanctions, FY 1999 Plan for Health Care Organizations," Daily Tax Report (BNA), G-1 (Sept. 18, 1998) ("DTR I").

34 Temp. Reg. §53.4958-3T(e)(2)(iii).

35 United Cancer Council, Inc. v Commissioner, 109 T.C. No. 17 (Dec. 2, 1997) (fundraiser for charity found to be an insider), rev'd, 165 F.3d 1173 (7th Cir. 1999).

36 Temp. Reg. §53.4958-4T(a)(3); 66 Fed. Reg. at 2155. The IRS also retained an example finding that a bingo operator with no apparent prior relationship to a charity was a disqualified person due to its control of an activity (bingo) generating more than half of the charity's annual revenue. Temp. Reg. §53.4958-3T(g), *Example 5*.

deciding whether to make it.[37] The inclusion of a reference to revenues generated by an activity of the exempt organization, coupled with the omission of any revenue-sharing rules, is consistent with the IRS intending to look only to the reasonableness of a revenue-based compensation arrangement to determine if an excess benefit exists.

An initial contract may provide for both fixed and non-fixed (i.e., discretionary) payments; however, the non-fixed payments will be subject to scrutiny under Section 4958. Therefore, while the person is protected from personal penalty excise tax liability for payments objectively established prior to such person entering into a position to exercise substantial influence, any subsequent discretion to be exercised when calculating, or deciding whether to make, the payment (which the then-disqualified person may have the ability to influence) may be scrutinized as a potential EBT.

A person may become a disqualified person during the term of such initial contract if the contract is materially modified (including an extension or renewal) or such person fails to substantially perform his or her obligations under the contract.[38] The examples (described below) touch on both of these scenarios. On the date of any modification, the contract would be treated as a new contract subject to evaluation under Section 4958 and the regulations.[39] The latter standard (substantial performance) is reminiscent of the disproportionate benefit standard that had been included in the proposed regulations in describing the standard for revenue sharing arrangements. In other words, if a contract provides on paper for a fair market value payment for services of equivalent value and party is paid in full but does not substantially perform its obligations, that party arguably received a disproportionate benefit.

Perhaps more troubling is the reference to treatment of cancelable contracts. The temporary regulations provide that if a contract is terminable or cancelable by the exempt organization without consent or penalty (other than for substantial nonperformance for this purpose), the contract will be treated as a new contract on the earliest date that such termination or cancellation could be effective.[40] This rule apparently would apply whether or not the termination or cancellation right is exercised, and would deprive all such contracts of the protection of the initial contract exception. Provisions for termination without consent (either with or without cause) or penalty are common in the health care sector and in fact for years unilateral without cause or penalty termination rights were virtually required for anything but employment contracts to satisfy the private use safe harbors for tax-exempt bonds.[41] Moreover, the legislative history of TBOR2 suggests that "material modifications" would end grandfathering protection for a contract.[42] The legislative history, however, does not include any such clear statement of Congressional intent for contracts that are simply terminable by the exempt organization. Although not stated in the preamble, the rationale for this third exception must be that if the exempt organization has the opportunity to extricate itself from a contract that

37 66 Fed. Reg. at 2150; Temp. Reg. §53.4958-4T(a)(3)(ii).

38 Temp. Reg. §53.4958-4T(a)(3).

39 Temp. Reg. §53.4958-4T(b)(2)(ii).

40 Temp. Reg. §53.4958-1T(f)(2), -4T(a)(3)(v) & -4T(b)(2)(ii).

41 Rev. Proc. 97-13, 1997-1 C.B. 632.

42 H.R. 104-506.

pays an excess benefit and it does not do so, it should be treated the same as if the contract had expired and then been renewed (without any grandfathering protection under TBOR2).

The temporary regulations also include eleven examples illustrating the application of the initial contract rule (generally assuming that the other party had substantially performed the contract obligations): (1) CPI adjuster: five-year contract for CFO (not previously a disqualified person) with a $200,000 annual salary payable monthly and adjusted based on changes in the CPI qualifies for the initial contract exception; (2) performance bonus: same facts plus an annual performance review bonus determined at year end by the board and capped at $100,000 (salary qualifies for the exception but the bonus portion does not); (3) immaterial modifications: changing from monthly to biweekly pay periods and adding two days paid vacation does not constitute a material change to an initial contract and the exception still applies; (4) material modifications: CFO's promotion to CEO and increase in salary from $200,000 to $240,000 constitute material changes requiring a reevaluation of the contract under the EBT rules; (5) fixed percentage bonus: CEO paid a fixed salary plus a bonus equal to 2% of the amount of season ticket sales over a threshold is a contract with a fixed payment because the bonus is not subject to discretion in the calculation of the bonus amount; (6) contracts with related parties: hospital COO becomes a disqualified person upon signing an initial contract so that when the COO, acting within his authority as COO, contracts for billing services with an entity owned more than 35% by the COO, the billing company is already a disqualified person and can not qualify for the initial contract exception – the COO's own contract does not cover the billing services payments because those payments are not made pursuant to the COO's employment contract; (7) percentage management fees: hospital management agreement providing for a percentage management fee qualifies for the exception where the fee a specified percentage of gross revenues adjusted (increased) for the cost of annual charity care for a five-year period calculated under a specific cost accounting system and standards (i.e., that is a fixed payment because the fee is determined by a fixed formula specified in the contract); (8) reimbursement of expenses: on the other hand if that same management contract provides for reimbursement of expenses paid to third parties (e.g., legal fees) would not be a fixed payment because the management company has discretion in how much it incurs in such expenses (the reimbursement payments would be analyzed separately as a potential EBT); (9) multiple bases for being a disqualified person: a researcher who first becomes a disqualified person by virtue of the initial contract and later, due to changed circumstances (marrying the child of the CEO), becomes a disqualified person separate and apart from the contract, is not deprived of the protection of the initial contract exception; (10) loan commitment: if the contract (signed pre-marriage) provides the same researcher with a unilateral right to borrow up to a specified dollar amount from the exempt organization at a specified rate of interest, the loan is within the initial contract exception because it is provided for in the original contract signed before there was any other basis for the person to be a disqualified person; and (11) breach of contract: if the researcher breaches the contract by working only sporadically at the laboratory yet is not fired and is still paid, the initial contract exception would no longer apply because the researcher substantially failed to perform his/her contractual obligations.[43]

These examples illustrate that the amount of the compensation package *per se* should have no bearing on whether or not the initial contract exception applies. That does not mean,

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43 Temp. Reg. §53.4958-4T(a)(3)(vii).

however, that any or all of these examples necessarily would or would not be an EBT but for the initial contract exception. Rather, but for that exception, one would need to analyze the arrangements on a case-by-case basis. For example, the first management contract example demonstrates that percentage based management contracts can be acceptable for an organization for EBT purposes, at least for the initial contract. Yet in Rev. Rul. 98-15 the IRS was critical of certain long-term management contracts and for tax-exempt bond purposes, the terms of percentage compensation arrangements may be limited (see Rev. Proc. 97-13). The management contract example also implicitly recognizes that the IRS will view accounting for and incenting charity care in a positive light. The expense reimbursement scenario is contrary to the treatment of third party expenses in applying the tax-exempt bond private use safe harbors of Rev. Proc. 97-13 (which ignores such payments entirely). The express assumption in the regulations that the other party had substantially performed the contract obligations highlights the need for exempt organizations to monitor and document contract performance and not limit the documentation to verifying fair market value on the front end of a transaction.

Rev. Rul. 98-15. Both of the fact patterns described in Rev. Rul. 98-15 involved whole hospital joint ventures between a nonprofit and a for-profit hospital company.[44] There was a management contract for the hospitals in each venture with a for-profit management company (one related and one unrelated to the for-profit joint venturer). In each case, the nonprofit relied primarily on its participation in the venture for its exempt status. In an example that is strikingly similar to both factual situations in Rev. Rul. 98-15, the temporary regulations state that the management company (without mentioning if it is related to either venturer) would be a disqualified person because of its substantial influence flowing from its day-to-day control over the joint venture hospitals where ownership in the venture is the nonprofit's primary asset.[45]

Affiliated Groups and Indirect EBTs. Excess benefits are taxable even if provided indirectly through another entity owned or controlled by or affiliated with an exempt organization.[46] Specifically, the temporary regulations include a new provision that an applicable tax-exempt organization provides an economic benefit indirectly through an intermediary when: (1) an applicable tax-exempt organization provides an economic benefit to a third party (the intermediary); (2) the intermediary provides economic benefits to a disqualified person of the applicable tax-exempt organization; and (3) either (a) there is evidence of an oral or written agreement or understanding that the intermediary will transfer property to a disqualified person; or (b) the intermediary lacks a significant business purpose or exempt purpose of its own for engaging in such a transfer.[47]

The temporary regulations also include four new examples illustrating different fact patterns under which economic benefits are provided indirectly to a disqualified person through a controlled entity or through an intermediary: (1) dual employers: employee of parent also provides services for and is paid by a subsidiary (no EBT because total payments equal value of total services required); (2) duplicate payment for services: CEO of parent, who is paid

[44] Rev. Rul. 98-15, 1998-12 I.R.B. 6; G. Griffith, "Revenue Ruling 98-15: Dimming the Future of All Nonprofit Joint Ventures?" 20 The Exempt Organization Tax Review 405 (June 1998).

[45] Temp. Reg. §53.4958-3T(g), *Example 7*.

[46] H.R. 104-506 at n. 3; Temp. Reg. §53.4958-4T(a)(2).

[47] Temp. Reg. §53.4958-4T(a)(2)(iii).

maximum reasonable compensation for those services, also contracts to provide consulting services for and is paid by a subsidiary (entire consulting services payment is an EBT because the consulting services are services the CEO is already required to provide and is paid for as CEO of the parent); (3) reasonableness of aggregate compensation and services: CEO of taxable subsidiary also serves on parent's board, the compensation paid for board service is reasonable but the total compensation from parent and subsidiary exceeds the value of the total services (as CEO and board member) to parent and subsidiary (entire consulting services payment is an EBT because the consulting services are services the CEO is already required to provide and is paid for as CEO of the parent); and (4) coincidental and unintended benefits: exempt organization funds research grant to unrelated company, that company advertises for research position and hires a former employee of the exempt organization who is still a disqualified person (within five year look-back period) but there was no oral or written understanding to use grant proceeds to provide a benefit to the former employee (not an EBT through use of an intermediary because the research company had a significant business purpose for the hiring).[48]

As these examples themselves illustrate at least indirectly, such indirect intercorporate relationships can complicate and expand the analysis of who is a disqualified person. It also places a premium on exempt organizations cataloging and tracking all arrangements with potential disqualified persons, even if technically paid by separate but related entities. The temporary regulations note that a person may be a disqualified person as to multiple related organizations. Yet the temporary regulations also provide that where organizations are "affiliated by common control or governing documents, the determination of whether a person does or does not have substantial influence shall be made separately for each . . . organization."[49] Under this standard, a person may be in a position of substantial influence over a subsidiary but not have substantial influence over the affairs of the parent or a brother-sister corporation. On the surface, this appears to be a departure from the IRS' model conflicts of interest policy which indicates that where a person would be deemed to have a financial interest in an organization if that person has a financial interest in any affiliate,[50] and with the legislative history of TBOR2 which states a similar attribution rule for anyone in a position to exercise substantial influence over a controlled affiliate of an exempt organization, even a taxable subsidiary.[51] Read together with the commentary in the preamble and the provisions related to indirect benefit and the functioning of the rebuttable presumption procedure in a corporate system, it appears that the IRS focus on this entity by entity classification is intended to allow tracing the excess benefit through a corporate chain asking for each link whether the person is a disqualified person as to that link in the chain.

Organization Managers

General Definition. An organization manager is defined in the temporary regulations as an officer, director or trustee of the exempt organization or any individual with similar powers or responsibilities. A person will be considered to be an officer of the organization if he/she is

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[48] Temp. Reg. §53.4958-4T(a)(iv).

[49] Temp. Reg. §53.4958-3T(f).

[50] See CPE Text (FY1997), Chapter C; CPE Text (FY2000), Chapter E; G. Griffith, "IRS Changes Stance on 'Impractical' 20 Percent Safe Harbor for Physician Control," 5 Health Law Reporter (BNA) 799 (May 23, 1996).

[51] H.R. 104-506 at n. 10, *reprinted in* the IRS FY1997 CPE Text at pp. 401-412.

designated as an officer in the governance documents or he/she "regularly exercises general authority to make administrative or policy decisions on behalf of the organization."[52] The temporary regulations indicate that "[a]ny person who has authority merely to recommend particular administrative or policy decisions, but not to implement them without approval of a superior, is not an officer" (and presumably not an organization manager).[53] Anyone who is not otherwise an organization manager, however, will become an organization manager by serving on a committee charged with conducting review of transactions to establish a rebuttable presumption of fair market value.[54] In addition, an organization manager who receives an excess benefit in the transaction also may be subject to the 225% penalty excise tax as a disqualified person.[55]

Professional Advisors. Independent valuation experts, attorneys, accountants, investment managers or advisors serving only in that capacity as independent contractors, are not organization managers.[56] Such professionals and their firms, however, still may be disqualified persons even with no prior relationship to the organization. To avoid that possibility, these professionals may need to look to their own internal conflicts of interest policies. One example in the temporary regulations suggests that generally an accountant will not be a disqualified person simply because he/she receives a fee for services where, pursuant to a conflicts of interest policy, the firm does not provide any services relating to a transaction from which it or its employees/owners might derive an economic benefit (aside from the professional fees).[57]

Participation. Organization managers are liable for the penalty excise tax only with respect to EBTs in which they knowingly and willfully participate without reasonable cause to believe it is not an EBT. The temporary regulations would define "participation" as both active and passive (e.g., silence or inaction in circumstances where the organization manager has a duty to speak or act). In other words, simply burying one's head in the sand and ignoring a problem is not a protection from penalty excise tax liability if an organization manager has a contractual or fiduciary duty to take action. If, however, the organization manager opposes the transaction in a manner consistent with fulfillment of his/her responsibilities, he/she will not be deemed to have participated in the transaction.[58]

Knowing. Participation will be considered "knowing" only if the organization manager (1) has actual knowledge of sufficient facts to conclude, on that basis alone, that a transaction would be an EBT, (2) is aware that his/her action "may violate" provisions of the Code applicable to EBTs, and (3) either is aware that it is an EBT or "[n]egligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction." According to the temporary regulations, merely having reason to know of facts or legal rules that would indicate that a transaction is an EBT does not alone satisfy the knowledge requirement.

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52 Temp. Reg. §53.4958-1T(d)(2)(i)(A) & (B).

53 Temp. Reg. §53.4958-1T(d)(2)(i)(B).

54 Temp. Reg. §53.4958-1T(d)(2)(ii).

55 Temp. Reg. §53.4958-1T(a).

56 Temp. Reg. §53.4958-1T(d)(2)(i)(B).

57 Temp. Reg. §53.4958-3T(g), *Example 12*.

58 Temp. Reg. §53.4958-1T(d)(3).

Having "reason to know," however, would be relevant in determining whether there was actual knowledge.[59]

Willful. Participation will be considered willful if it is "voluntary, conscious, and intentional;" however, no particular motive is required. As with the definition of "knowing," participation will not be willful if the organization manager does not know that the transaction is an EBT.[60]

Reasonable Cause and Professional Advisors. Organization managers can not be held liable for a penalty excise tax under TBOR2 if they have reasonable cause to believe that a transaction does not result in an excess benefit. The temporary regulations state that participation is based on reasonable cause where the organization manager exercised his/her responsibilities on behalf of the organization "with ordinary business care and prudence."[61] Under both the proposed and temporary regulations, receipt of certain favorable legal opinions would ordinarily demonstrate reasonable cause, even if the transaction is later found to be an EBT. Although in-house counsel may render these opinions, if they themselves have participated in the transaction as an organization manager it would raise interesting questions of whose opinion in-house counsel could rely on to establish reasonable cause for his or her actions.

Perhaps in part with that in mind and to remedy other uncertainties as to the appropriate scope of a legal opinion, the IRS expanded this safe harbor in the temporary regulations to allow reliance on CPAs (presumably including in-house CPAs though the regulations are silent on that point) or accounting firms with expertise in relevant tax law matters. The temporary regulations also would include safe harbor protection for organization managers relying on the opinion of independent valuation experts (use of the term independent suggests an in-house expert would not suffice for the safe harbor) if such experts (1) hold themselves out as appraisers or compensation consultants; (2) perform the relevant valuations on a regular basis; (3) are qualified to make valuations of the type of property or services being valued; and (4) include in the written opinion a certification that they meet the preceding requirements.[62]

Satisfaction of this safe harbor requires that the professional advisor's opinion be a reasoned, written opinion. There must be full disclosure of all of the facts to the professional advisor and the opinion must conclude that the transaction is not an EBT. In order to qualify as a reasoned opinion, the opinion letter must do more than recite the facts and set forth a conclusion, rather it must address the facts and the applicable standards in some detail.[63] It is still unclear what effect standard assumptions and exceptions in opinions of professional advisors will have on their usefulness in establishing reasonable cause; however, the expansion to include CPAs and valuation experts does address one question – whether attorneys will be expected to opine on fair market value rather than assume it or disclaim that opinion as is typically the case. Determinations of whether or not an excess benefit is provided are heavily dependent on factual

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59 Temp. Reg. §53.4958-1T(d)(4).

60 Temp. Reg. §53.4958-1T(d)(5).

61 Temp. Reg. §53.4958-1T(d)(6).

62 66 Fed. Reg. at 2146; Temp. Reg. §53.4958-1T(4)(iii)(C).

63 Temp. Reg. §53.4958-1T(d)(4)(iii).

questions of fair market value that are not strictly legal matters. Now the IRS has provided an alternative to cover the gap when legal opinions assume or disclaim any opinion on fair market value. To cover that gap, the organization can obtain an independent appraisal of fair market value. This approach is consistent with the temporary regulations which state that organization managers can rely on opinions of these professional advisors "with respect to elements of the transaction within the professional's expertise."[64]

In response to comments on the proposed regulations, the temporary regulations also contain a new safe harbor providing that an organization manager's participation in a transaction ordinarily will not be considered knowing if the manager relies on the fact that all of the requirements giving rise to the rebuttable presumption of reasonableness are satisfied with respect to the transaction.[65] Even without this or the professional advisors safe harbor, reasonable cause still can be established on a facts and circumstances basis, and failure to obtain an opinion or follow the rebuttable presumption procedure does not create any negative inference on the question of reasonable cause.[66] (The regulations do not give any examples of when the "ordinary" protection of the safe harbors would not apply, but likely it would require proof of actual knowledge of excess benefit and that the opinion or rebuttable presumption review was a sham.)

$10,000 Limit. Both the Code and the temporary regulations limit an organization manager's liability to $10,000 for any one EBT.[67] Given the broad provisions in the temporary regulations for treating a single cancelable contract as a new contract as of each potential cancellation date and similar provisions for treating materially amended contracts as new contracts,[68] organization managers could find themselves facing multiple $10,000 for what they thought was a single contract. It has also been suggested that each payment under a long-term contract might be considered a separate EBT. The temporary regulations do not expressly address that situation in the context of the $10,000 limit. However, the temporary regulations do state that once a rebuttable presumption is established for a contract, it protects "all payments made or transactions completed in accordance with [that] contract," except with respect to non-fixed payments, for which no presumption can arise until the amount is determined.[69] This last provision suggests that a single contract can consist of multiple transactions, an interpretation which Treasury officials perpetuated rather than clarified after the proposed regulations were released.[70]

Rebuttable Presumption Procedure

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64 Id.

65 Temp. Reg. §53.4958-1T(d)(4)(iv).

66 Temp. Reg. §53.4958-1T(d)(4)(iii) & -6T(e).

67 Code §4958(d)(2); Temp. Reg. §53.4958-1T(d)(7).

68 Temp. Reg. §53.4958-1T(f)(2), -4T(a)(3)(v) & -4T(b)(2)(ii).

69 Temp. Reg. §53.4958-6T(d) & (g).

70 See C. Wright, "ABA Tax Section Meeting: Treasury/Hill Officials Explain Intermediate Sanctions, Restructuring Act," Tax Notes Today, 98 TNT 149-1 (Aug. 4, 1998); 98 TNT 178-5, *supra*.

Compliance. To establish the presumption, the following three steps must be taken prior to making any payment to the disqualified person: (1) the arrangement must be reviewed and approved by the governing board, a committee thereof, or other parties with board-delegated authority under state law and acting within board-established procedures (in any case, an "authorized body") of an applicable tax-exempt organization or an entity controlled by the organization, and none of the members of the authorized body participating in the discussion or vote on the arrangement have a conflict of interest with respect to that arrangement; (2) the authorized body must rely on appropriate data as to comparable arrangements prior to making its determination; and (3) the authorized body must adequately document the basis for its decision concurrently in the minutes.[71] Although such an interpretation was implicit in the proposed regulations, the temporary regulations explicitly provide that compensation arrangements *in their entirety* must be evaluated (which should include the value of any in-kind payments).[72] The temporary regulations also provide that the governing board or committee of a controlled entity (even if it is taxable) can establish the presumption through review and approval of an arrangement, at least in connection with indirect transfers of economic benefits from the tax-exempt parent or affiliate.[73]

The temporary regulations outline, in greater detail, the same procedure for establishing a rebuttable presumption of fair market value as set forth in the legislative history, the proposed regulations and in instructions to Form 990.[74] By following this procedure, taxpayers can shift the burden of proof to the IRS to establish that a transaction is not at fair market value, rather than the taxpayer being required to prove it is. Moreover, following this procedure creates a safe harbor protecting organization managers against the 10% penalty excise tax.

Given the administrative burden and legal risks of following these detailed steps, many organizations still may conclude that the benefit of the rebuttable presumption may not be worth the costs. The administrative burden includes administering a detailed conflicts regimen following the IRS' broad definition of "conflicts," and compiling and maintaining detailed comparable data for all transactions with disqualified persons. Legal risks of following the procedure include establishing a road map for the IRS and other regulators to use against the hospital in investigations and for private parties and regulators to use in lawsuits related to discrimination, antitrust, breach of fiduciary duty or other claims. Ignoring the procedure, however, may void applicable insurance coverage as well as deprive Organization Managers of a potential safe harbor. As for the conflicts procedures, they may not be far removed from what many state laws require in terms of identifying and disclosing conflicts; however, state laws typically do not require that an interested director leave the meeting during a discussion and vote or even necessarily preclude his/her vote.[75]

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[71] Temp. Reg. §53.4958-6T(a) & (c).

[72] 66 Fed. Reg. at 2154; Temp. Reg. §53.4958-6T(c)(2).

[73] 66 Fed. Reg. at 2155; Temp. Reg. §53.4958-6T(a)(i).

[74] Temp. Reg. §53.4958-6T; H.R. 104-506 at nn. 5-7; Form 990 (2000), Instructions, p. 11, ¶P.

[75] See, e.g., Ariz. Rev. Stat. §10-2550; Del. Gen. Corp. Law §144; Fla. Stat. 617.0832; Ind. Code §23-17-13-2; Mich. Comp. Laws §450.2545; N.Y. Not-for-Profit Corp. Law (McKinney) §715; 15 Pa. Consol. Stat. §5728(a) & (b); Tex. Corps. Code §1396-2.30; Wis. Stat. §181.0831(1) & (2); Rev. Model Nonprofit Corp. Act §8.31.

Committee Composition; Delegation. One of the questions raised in the wake of TBOR2 was whether anyone other than directors, trustees and officers of the exempt organization can serve on the rebuttable presumption review committee. In addition, the preamble notes that the temporary regulations continue to allow the governing board to delegate approval authority consistent with state law; and the regulations themselves contemplate including or more persons on the committee who are not directors, trustees or officers of the exempt organization.[76] Such appointments and the authority delegated to the committee, however, must be valid under state law and a committee will not be deemed to have approved a transaction if its decisions are subject to review and ratification of the board in order to become effective.[77]

If permitted under state law, the board also may delegate approval authority to other parties under specified procedures. As long as the three basic elements for the presumption are incorporated in those procedures and are met, the rebuttable presumption will apply.[78] This delegation should be especially helpful for organizations that wish to delegate relatively smaller compensation decisions to management to avoid excessive time demands on the board or any committee. Under this approach, a board could delegate authority for specific types or values of transactions to management. Alternatively, a board could review and approve a group of transactions or a pay scale or formula to be administered by management and still be deemed to have established a rebuttable presumption if the formula or pay scale includes safeguards intended to limit compensation to fair market value. Although each individual transaction need not be reviewed, the board still should exercise appropriate oversight over management's activities in the compensation area to assure that the procedures are being complied with, a step that the IRS has suggested in prior guidance on physician recruitment programs.[79]

Conflicts of Interest. One of the key elements of establishing the rebuttable presumption is documenting that all of the individuals participating in the deliberation and vote on the arrangement were disinterested as to that arrangement. The IRS has developed a model conflicts of interest policy for exempt organizations. The temporary regulations echo the model conflicts policy by noting that interested individuals may attend the meeting only to answer questions and then must recuse themselves from the meeting. They can not be present for any debate or voting on the transaction.[80] The temporary regulations go even further and focus on specific types of relationships as potential conflicts. In that regard, there is a limited safe harbor for avoiding conflicts in the temporary regulations. A board or committee member does not have a conflict if he or she: (1) is not a party to and does not personally benefit from the transaction and none of his or her family members will participate in or economically benefit from the transaction; (2) is not in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefiting from the transaction; (3) is not receiving compensation or other payments subject to approval by any disqualified person participating in or economically benefiting from the transaction; (4) has no material financial interest affected by the transaction; and (5) does not approve a transaction providing economic benefits to any

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76 66 Fed. Reg. at 2154; Temp. Reg. §53.4958-1T(d)(2)(ii) & -6T(c)(1)(i).

77 Temp. Reg. §53.4958-6T(c)(1)(C).

78 Temp. Reg. §53.4958-6T(b).

79 See Rev. Rul. 97-21, 1997-18 I.R.B. 8.

80 Temp. Reg. §53.4958-6T(c)(1)(ii).

disqualified person participating in the transaction, who in turn has approved or will approve a transaction providing economic benefits to the member (i.e., no vote swapping).[81]

Comparable Data. The temporary regulations make it clear that the level of detail necessary in the supporting documentation to establish the rebuttable presumption depends on the level of knowledge and experience of the board or committee members. Relevant information for the board or committee to determine fair market value would include: (1) compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; (2) availability of similar services in the geographic area of the applicable tax-exempt organization; (3) current compensation surveys compiled by independent firms; (4) actual written offers from similar institutions competing for the services of the disqualified person; and (5) independent appraisals of the value of property that the applicable organization intends to purchase from, or sell or provide to, the disqualified person.[82]

Unfortunately, there is no reference to consideration of community benefit in this process; however, documented community benefit from an arrangement should remain a persuasive fact for the IRS. In addition, by limiting reliance on competing offers to "actual written offers from similar institutions," the temporary regulations serve to implicitly emphasize the risks inherent in relying on a disqualified person's verbal description of an offer (which may or may not exist as represented), even if she is prohibited from disclosing it by a confidentiality agreement. Also of note, references to independent salary surveys and appraisals suggest that the IRS may question comparable data that is merely compiled by the disqualified person herself by polling her colleagues at other organizations.

More important, perhaps, will be how the IRS ultimately defines "similar organizations" for this purpose, though clearly both taxable and exempt organizations are included. Other than that, the examples suggest a facts and circumstances approach. In the health care field, relevant factors will include size of the organization/facility, nature of services provided. Other variables are unclear but one could read the examples as differentiating by type of health care organization, i.e., treating a hospital different from a clinic, and a clinic from an HMO.[83]

The specific examples of comparable (and non-comparable) data in the temporary regulations emphasize the relationship between the knowledge and experience of the members of an authorized body and the level of detail required in the comparable data. In compensation matters, for example, based on their knowledge and experience, the members of the authorized body must be able to reasonably determine that the position they are reviewing and their organization are comparable to the positions and organizations represented in salary survey data. General business experience alone is not sufficient if the members of the authorized body do not have any particular expertise in compensation matters in the exempt organization's industry.[84] The first example is the most striking in this regard. In that situation, the committee members of a large university were reviewing the president's contract. They had no particular experience in

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81 Temp. Reg. §53.4958-6T(c)(1)(iii).

82 Temp. Reg. §53.4958-6T(c)(2)(i).

83 Temp. Reg. §53.4958-6T(c)(2)(iv), *Example 3*.

84 Temp. Reg. §53.4958-6T(c)(2)(iv), *Examples 1 & 3*.

higher education compensation matters even though they all had significant business experience. They relied on a national survey of compensation for university presidents, which did not divide its data by any measure of university size or any other criteria. Given the committee's lack of experience and the lack of specificity in the data, the IRS concluded that the committee did not have sufficient comparable data on which to base its decision.

In the second example, a hospital board did have sufficient comparable data where it relied on a customized compensation survey by an independent firm specializing in executive compensation consulting. The survey covered executives with comparable responsibilities at a significant number of hospitals, with data sorted by a number of variables including size of hospitals, nature of services provided, level of expertise and specific responsibilities of executives, and details of the compensation packages. Board members were also given the survey results, a detailed written analysis comparing the hospital's executives to the survey sample, and an opportunity to ask questions of the consultant. The second example in particular emphasizes that the review process should include some discussion and evaluation of the individual's prior performance, qualifications and experience, and the comparable data. One of the new examples added in the temporary regulations also highlights that if the board or committee has no indication market conditions have changed, it can continue to rely on prior comparability data.[85] The temporary regulations also loosened the standards for small organizations to establish comparability (reduced from five to three comparable sources), though most health care organizations would exceed the $1 million gross receipts threshold for "small organizations."[86] Moreover, in the preamble the IRS clarifies that larger organizations (including virtually all tax-exempt health care providers) must have more extensive comparability data to support the reasonableness of a total compensation package.[87]

Written Documentation. The temporary regulations also include guidance as to the appropriate level of documentation to take advantage of the rebuttable presumption. For adequate documentation, the authorized body's minutes must be prepared and approved within the later of 60 days or the date of the next meeting and should include: (1) terms of the transaction; (2) date it was approved; (3) members of the authorized body present during debate and those who voted on the transaction; (4) comparability data obtained and relied upon by the authorized body and how the data was obtained; (5) actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction; and (6) if the authorized body determines that fair market value in a specific transaction is higher or lower than the range of comparable data obtained, the minutes must state the basis for that determination.[88]

It is this last criterion that critics will point to in particular as an indication that the rebuttable presumption procedure is nothing more than a road map for investigators. To some extent, it is just that. Yet it is also an opportunity to force a reasoned and defensible conclusion within the organization and to reject compensation demands that simply cannot be supported.

85 Temp. Reg. §53.4958-6T(c)(2)(iv), *Example 4*.

86 Temp. Reg. §53.4958-6T(c)(2)(ii) & (iv), *Example 5*.

87 66 Fed Reg. at 2154.

88 Temp. Reg. §53.4958-6T(c)(3).

There is, for example, favorable case law supporting the reasonableness of compensation for deductibility purposes under Section 162 (a similar standard of reasonableness) where the amount paid exceeds what would otherwise be fair market value based on specific, meritorious circumstances such as a history of an executive being underpaid by the organization,[89] or perhaps as a reward for past performance and a history of loyal service. In fact, one senior Treasury Department attorney commented that it would be "permissible to take prior year services into account, so that a catch-up payment in a current year would not be an excess benefit, and that it would not be necessary to allocate it to prior year services."[90] If such reasons exist, it is generally more likely that they can be documented at the time of the decision than after the fact. Moreover, documentation developed years after the fact may have limited credibility and may be viewed as done from the perspective of hindsight when reasonableness, with or without the rebuttable presumption, is generally to be determined as of the time the contract is entered into.[91]

The temporary regulations clarify that in order for a decision to be documented concurrently, the minutes must be prepared by the next meeting of the authorized body and must be reviewed and approved before the later of the next meeting or 60 days after the final action(s) of the authorized body are taken. It is equally important to maintain documentation that these procedures have been followed. Many health care organizations have record retention policies that provide for destruction of certain records after stated periods of time, usually tied to statutes of limitation. The preamble to the temporary regulations indicated that "[b]ooks and records relating to a collection of information [as part of the rebuttable presumption process] must be retained as long as their contents may become material in the administration of any internal revenue law."[92] In this regard, it should be noted that there is no statute of limitations on revocation of exempt status and extreme excess benefits or a pattern of EBTs may warrant revocation of exemption.[93] Because the rebuttable presumption may be instrumental in defending a proposed revocation, prudence dictates maintaining these records indefinitely in a permanent file.

Future Determinations of Reasonableness. The rebuttable presumption applies to all fixed payments (including payments pursuant to a qualified pension, profit-sharing or stock bonus plan under Section 401(a)) or transactions completed in accordance with the contract provided that the three requirements of the rebuttable presumption were met at the time the contract was agreed upon.[94] The temporary regulations have been amended to provide that in the case of non-fixed payments, the rebuttable presumption cannot arise until circumstances exist

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[89] See, e.g., Choate Construction Co. v Commissioner, T.C. Memo. 1997-495.

[90] "Intermediate Sanctions May Become Final Later This Year, Treasury Official Predicts," Health Care Daily Report (BNA) (Feb. 2, 2001) (BNA summary of comments of Steven Arkin, hereafter "Intermediate Sanctions").

[91] See, e.g., Anclote Psychiatric Center, Inc. v Commissioner, T.C. Memo. 1998-273; Temp. Reg. §53.4958-4T(b)(2)(i).

[92] 66 Fed. Reg. at 2144.

[93] If a return is filed a three-year statute of limitations applies to the penalty excise taxes absent fraud; and reporting on the 990 may trigger that statute even without a filing by the disqualified person or organization manager. I.R.C. §6501; Treas. Reg. §301.6501(e)-1(c)(3)(ii).

[94] Temp. Reg. §53.4958-6T(f).

such that the exact amount of the payment is determined, or a fixed formula is specified, and the three basic requirements for the presumption subsequently are satisfied.[95]

The temporary regulations also add a special rule regarding employment contracts containing non-fixed payments (such as a discretionary bonus) subject to a specified cap. An authorized body now may establish a rebuttable presumption with respect to such a non-fixed payment at the time the contract is entered into if (1) the authorized body obtains appropriate comparability data in advance which indicates that a fixed payment up to a certain amount to a particular disqualified person would represent reasonable compensation, (2) the maximum amount payable under the contract (including both fixed and non-fixed payment amounts) does not exceed the reasonable compensation figure, and (3) the other requirements for establishing the rebuttable presumption are satisfied.[96] Despite this special rule for establishing the presumption as to capped non-fixed payments, the preamble states that the IRS may rebut the presumption of reasonableness with respect to a capped, non-fixed payment based on all facts and circumstances up to and including circumstances as of the date of payment under the general rules for the timing of the reasonableness determination.[97]

Rebuttal or Lack of Any Presumption. The presumption is rebuttable by the IRS, but only if it demonstrates sufficient contrary evidence to rebut the probative value of the evidence presented by the parties to the transaction.[98] It may be rebutted, for example, by challenging the independence of the reviewing body or challenging the comparability of the data relied on in the review process.[99] Failure to follow the rebuttable presumption procedure, however, does not create an inference of excess benefits. Nor does following the procedure relieve anyone from compliance with other state and federal laws concerning the operations of the organization.[100] For health care organizations, for example, compliance with IRS rules does not necessarily guaranty compliance with other health care regulatory restrictions such as fraud and abuse and self-referral laws and regulations.

Indemnity and Insurance

In addition to following the rebuttable presumption process, organization managers (and, with less success, disqualified persons) may seek indemnification or insurance coverage from the exempt organizations they serve. If insurance is purchased, only the premium amount must be treated as compensation for purposes of Section 4958. Insurance premiums and indemnity payments would be excluded from the calculation, however, if they qualify as *de minimis* fringe benefits excludable from income under Section 132(a)(4).[101] In addition, the temporary regulations clarify that absent such an exclusion, any insurance premium or indemnity payment paid by an applicable tax-exempt organization for (a) any penalty, tax or expense of correction

[95] Temp. Reg. §53.4958-6T(d)(1).

[96] Temp. Reg. §53.4958-6T(d)(2).

[97] 66 Fed. Reg. at 2155.

[98] Temp. Reg. §53.4958-6T(b).

[99] Temp. Reg. §53.4958-6T(b).

[100] Temp. Reg. §53.4958-6T(e).

[101] 66 Fed. Reg. at 2151; H.R. 104-506 at n. 9.

under Section 4958, (b) any expense not reasonably incurred in connection with a civil judicial or administrative proceeding arising out of the person's services on behalf of the organization, or (c) any expense resulting from the person's willful act or failure to act (i.e., no reasonable cause for such act or failure to act) is itself an excess benefit unless it is treated as compensation and total compensation is reasonable.[102]

If an indemnity agreement is broad in terms of the covered excess benefit tax liability and is not a *de minimis* fringe benefit, it still raises the potential of a never-ending upward spiral, with each indemnity payment becoming an excess benefit triggering another indemnity payment (e.g., **A** receives a $100,000 excess benefit, the indemnity from **EO** pays the 25% tax, or $25,000; **A** does not repay **EO** so **EO** then pays the 200% tax as well, or $200,000; the total of $225,000 is itself a taxable excess benefit on which **EO** pays the 25% tax and then the 200% tax, and the cycle repeats). Insurance is likely to be difficult if not impossible to procure for penalty excise tax liability for disqualified persons. Some insurers, however, have offered to write organization manager coverage. Typical conditions or restrictions of such coverage may include a commitment to follow the rebuttable presumption process.

Fair Market Value

The temporary regulations include a customary definition of fair market value for the transfer of ownership or use of property: “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.”[103] Although the definition does not require an appraisal, in order to take advantage of the rebuttable presumption of fair market value some comparable data (such as an appraisal) will be needed. For example, in prior binding guidance the IRS indicated that where the seller is in a position to exercise influence or control over the purchaser at the time of the sale (the essence of being a disqualified person) and the transaction is not at arm’s length, the normal presumption of a negotiated price being fair market value does not apply and an independent appraisal is needed for any intangible assets sold.[104] Obtaining an appraisal is also a good means of assuring compliance with fraud and abuse and self-referral laws (even though other steps are obviously needed in that regard).

Reasonable Compensation

The temporary regulations do not establish any bright-line tests or per se safe harbors for determining what amount of compensation is reasonable. They do, however, provide guidance through an outline of general principles to be followed in determining reasonableness based on all of the relevant facts and circumstances. Specifically, the regulations provide that “[c]ompensation for the performance of services is reasonable if it is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.”[105] The

[102] Temp. Reg. §53.4958-4T(b)(1)(ii)(B)(2); H.R. 104-506 at n. 9.

[103] Temp. Reg. §53.4958-4T(b)(1)(i).

[104] Rev. Rul. 76-91, 1976-1 C.B. 150.

[105] Temp. Reg. §53.4958-4T(b)(1)(ii).

temporary regulations also clarify that the inclusion of an item in compensation for Section 4958 purposes does not govern its income tax treatment, i.e., the Section 4958 benefits include some items that are not necessarily taxable income.[106]

Time of Determination. Under the temporary regulations, reasonableness of compensation is generally determined at the time the parties enter into the agreement, with two exceptions – substantial nonperformance (fixed payment contracts) and need for additional facts and circumstances (non-fixed payment contracts). In either case, if there is substantial nonperformance by the other party of its contractual duties or if reasonableness can not be determined based on circumstances existing at the time the contract is entered into, the determination is made based on all of the facts and circumstances up to and including the date of payment. The determination will not, however, be made on the basis of circumstances existing when the IRS questions the contract.

Contractual provisions for increases in compensation based on changes in the Consumer Price Index (CPI), varying benefits based on what is provided to other employees, and tying retirement benefits to the maximum amount permitted under rules applicable to qualified retirement plans are examples of variables that do not affect the ability to determine reasonableness of fixed compensation when the contract is signed. In the case of a non-fixed payment, however, reasonableness is based on all facts and circumstances up to, and including, the date of payment. For example, provision for a bonus that is completely within the discretion of the board with no specific limitations or guidelines is a variable that makes it impossible to determine the reasonableness of the recipient's compensation in advance of the board actually making the bonus determination.[107] In determining the reasonableness of compensation, the same standards that apply to deductibility for for-profits (i.e., those under Section 162 of the Code) also apply to nonprofit compensation reasonableness, taking into account all benefits provided to a person (other than those specifically disregarded under Section 4958) and the rate at which any deferred compensation accrues.[108] Discretionary bonuses are not uncommon in health care today, though for physicians the Stark Law and fraud and abuse rules tend to focus on compensation plans being determined in advance with some specificity.

Legislative and Court Approval. The temporary regulations note that state legislative or agency approval and court approval of a payment is not determinative of reasonableness.[109] This was one of the points of contention in the recent Bishop's Estate case involving school trustees in Hawaii. Additionally, under this standard simply paying a court judgment could result in an EBT. This approach is consistent with prior guidance where the IRS focused on the purpose of litigation and its relationship to charitable functions to determine whether payments in satisfaction of claims resulted in inurement or otherwise jeopardized exempt status (the payments were upheld based on their relationship to an underlying charitable purpose).[110] The temporary

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106 66 Fed. Reg. at 2151; Temp. Reg. §53.4958-4T(b)(1)(ii)(C).

107 Temp. Reg. §53.4958-4T(b)(2)(iii), *Example 2*.

108 Temp. Reg. §53.4958-4T(b)(1)(ii).

109 Temp. Reg. §53.4958-4T(b)(1)(ii).

110 See, e.g., Rev. Rul. 78-41, 1978-1 C.B. 148 (malpractice trust); GCM 39562 (Oct. 8, 1986) (defense of libel suit); LTR 8818012 (Feb. 4, 1988) (settlement of "genuine dispute and controversy" regarding rights to trust corpus).

regulations, however, do not expressly state that a court judgment is irrelevant, just that it is not determinative. In this regard, the IRS' concern may be that if a court order were sufficient to shelter any arrangement, disqualified persons could enter into blatant EBTs with exempt organizations yet avoid any penalty excise tax liability by going to court to obtain a judgment to enforce the contract (assuming the contract would not be rendered void on public policy grounds for misuse of charitable assets).

Includible Compensation. In assessing reasonableness of compensation, the term "compensation" is very broadly defined and would include economic benefits provided to a disqualified person directly or indirectly either through a controlled entity or an intermediary.[111] All forms of cash and non-cash compensation must be considered, whether or not they are taxable income, including: salary; fees; bonuses; severance payments; fringe benefits (e.g., health and welfare plans, dental, disability, life insurance, severance, etc., whether or not included in income, but excluding working condition fringe benefits described in section 132(d) and *de minimis* fringe benefits described in section 132(e)); incentives; all deferred compensation that has vested or is no longer subject to a substantial risk of forfeiture (whether or not funded and whether or not included in a qualified plan); premiums for insurance against penalty excise tax liability under Section 4958 and any indemnity or other payment of such tax liability; expense allowances or reimbursements; and forgone interest on loans.[112] In addition, the preamble reveals that the IRS and Treasury believe that any economic benefit received by a disqualified person from the assets of the organization is deemed to be provided by the organization, even if the transfer of the benefit was not authorized by the organization (i.e., embezzled amounts – suggesting that in addition to filing a criminal report in cases of suspected embezzlement an exempt organization needs to consider reporting the suspected theft on its Form 990 as an EBT).[113]

Cap on Bonus. Notably absent from the list of factors (as opposed to prior IRS guidance) in the 1998 proposed regulations on revenue sharing was any reference to a cap on total compensation or on the total amount of the incentive payment.[114] This omission has been corrected in the temporary regulations, where the IRS provides that a cap on a bonus or revenue sharing arrangement is a favorable factor in determining reasonableness of compensation.[115] One IRS official previously noted that revenue sharing arrangements may be problematic if there is a possibility of a windfall to a disqualified person with no external controls for the organization to limit the windfall and no "look back" feature in the arrangement to review total payments and avoid or correct a windfall.[116] Of course, any compensation package that exceeds a reasonable amount with or without a cap may be an EBT and may implicate other laws as well.

Intent to Treat as Compensation. The proposed regulations provided that in order for a payment to be treated as compensation for services, the intent to treat the payment as

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111 66 Fed. Reg. at 2149; Temp. Reg. §53.4958-4T(a)(2).

112 Temp. Reg. §53.4958-4T(a)(1) & -4T(b)(1)(ii)(B).

113 66 Fed. Reg. at 2149.

114 See, e.g., GCM 38905; GCM 38322.

115 Temp. Reg. §53.4958-4T(b)(1)(ii)

116 See DTR I, *supra*.

compensation must be "clear and convincing" at the time the payment is made.[117] Consistent with the legislative history, however, the temporary regulations provide instead that an organization must provide "written substantiation that is contemporaneous with the transfer of benefits at issue."[118] Unless the benefits are nontaxable and specifically disregarded under Section 53.4958-4T(a)(4), they must be considered when determining the reasonableness of a disqualified person's compensation. For example, the legislative history indicates that a payment should be approved in the normal manner in which the organization approves compensation and reported on all applicable tax forms (e.g., Forms W-2, 1099 and 990, except that nontaxable fringe benefits need not be reported on Form W-2 or 1099).[119]

The temporary regulations provide safe harbors to assure treatment of payments as compensation for services if: (1) the organization reports the benefits provided as compensation on its applicable information returns filed before the start of any IRS Exempt Organizations examination in which reporting of the benefit is questioned (including notice of any impending audit, referral for audit or appeal of an audit for that period); (2) the disqualified person reports the benefit as income on Form 1040 or other federal tax return (e.g., Form 1120); (3) other written contemporaneous evidence demonstrates that the appropriate decision-making body or an authorized officer approved the transfer as compensation for services in accordance with established policies and procedures; or (4) the organization's failure to report is due to reasonable cause, based on a showing of "significant mitigating factors" or events outside its control, and the organization acted responsibly in such matters before and after the failure. One example of a reasonable cause failure to report due to circumstances beyond the organization's control involves an organization that includes a written description of its COO's bonus arrangement in the COO's personnel file. The personnel handbook specifies that all bonuses are reported on the employee's Form W-2 but due to a computer glitch the COO's bonus is not reported. As soon as the oversight is discovered an amended Form W-2 is filed.[120]

Consistent with the legislative history, the temporary regulations also added a safe harbor for nontaxable benefits. An exempt organization is not required to indicate its intent to provide an economic benefit as compensation for services if the economic benefit is excluded from the disqualified person's gross income for income tax purposes under Chapter 1 of Subtitle A of the Code.[121] Examples of excluded benefits include: employer-provided health benefits, contributions to a qualified pension, profit-sharing, stock bonus plans under Section 401(a) of the Code, and benefits described in Sections 127 and 137 of the Code.

Moreover, the temporary regulations note that these are not the only means by which an organization can show sufficient intent to treat a benefit as compensation for services.[122] Another example would be a written service contract with a corporation (other than a medical

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117 Prop. Reg. §53.4958-4(a)(1) & (c). This position echoes existing case law. See, e.g., John Marshall Law School v U.S., 81-2 USTC ¶9514 (Ct. Cl. 1981).

118 66 Fed. Reg. at 2152; H.R. 104-506 at N.8; Temp. Reg. §53.4958-4T(c)(3).

119 H.R. 104-506 at n. 8.

120 Treas. Reg. §301.6724-1(b)–(d); Temp. Reg. §53.4958-4T(c) & -4T(c)(4)(iii), *Example 2*.

121 66 Fed. Reg. at 2152; H.R. 104-506 at n. 8; Temp. Reg. §53.4958-4T(a)(4) & (c)(2).

122 Temp. Reg. §53.4958-4T(c)(3)(ii).

corporation) where a Form 1099 is not required by law to be filed.[123] Whichever approach is followed, the records should be maintained for so long as the transaction is potentially subject to the penalty excise taxes under Section 4958 of the Code (generally three years assuming returns are promptly filed and accurate and there is no fraud). Correctly reporting payments as compensation thus continues to be useful in safeguarding compensation arrangements. On the other hand, failure to report (absent reasonable cause) may lead an agent to argue that a payment actually was not intended for services and was merely a gratuitous payment to a disqualified person and thus an EBT.

Deferred Compensation

The value of benefits provided to a disqualified person is generally measured at the date the potential EBT occurs absent a specific exception. Section 53.4958-1T(e) provides that an EBT generally "occurs" on the date that the disqualified person receives the excess benefit. In the case of deferred compensation, however, "the transaction occurs on the date the deferred compensation is vested" or (for Section 83 transfers of property and Section 457 nonqualified deferred compensation) when the substantial risk of forfeiture lapses.[124] The proposed regulations provided an exception to the general rule that deferred compensation need not be counted in assessing reasonableness of compensation until "vested." Under the proposed regulations, if the deferred amount was earned over multiple years of service but did not vest until a later year, it would be allocated for TBOR2 purposes based on the year in which the services were provided (e.g., a $100,000 deferred compensation amount that vests after four years of service would be allocated pro rata, $25,000 to each of the four years even before the vesting period ends).[125] The temporary regulations eliminate that exception and instead provide that reasonableness will be determined in the year the deferred compensation is vested or is no longer subject to a substantial risk of forfeiture, but in making that determination, "services performed in prior years may be taken into account."[126]

Nontaxable Incidental Benefits

The temporary regulations include four circumstances where any excess benefit would be disregarded. In effect, these are exceptions for incidental benefits. First, all fringe benefits excluded from income under Section 132 of the Code (except for certain liability insurance premiums, payments or reimbursements, as discussed above) will be disregarded. This exception replaces the provision in the proposed regulations that payment or reimbursement of a board member's reasonable expenses of attending board meetings would be disregarded. In addition, in relying on Section 132, the temporary regulations adopt existing standards under Sections 162 and 274 (which are incorporated into Section 132) to determine whether payments or reimbursements of travel or other expenses of an employee should be disregarded for Section 4958 purposes or treated as part of the disqualified person's compensation. Second, economic benefits provided to a disqualified person "solely as a volunteer for the organization" will be

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[123] Temp. Reg. §53.4958-4T(c)(3)(ii) and (c)(4)(iii), *Example 1*.

[124] Temp. Reg. §53.498-1T(e)(2).

[125] Prop. Reg. §53.4958-4(b)(3)(ii)(B).

[126] Temp. Reg. §53.4958-4T(a)(1).

disregarded if the benefit is also provided to the general public for an annual membership fee of $75 or less (e.g., advance ticket purchasing privileges and a gift shop discount – from the proposed regulations). Third, economic benefits provided to a member of an organization of any value (the proposed regulations had capped the value of the benefit at $75) solely on account of the payment of a membership fee, or to a donor solely on account of a contribution under Section 170, if (a) any non-disqualified person that makes a comparable payment or contribution has the option of receiving substantially the same economic benefit, and (b) the disqualified person and a significant number of non-disqualified persons in fact do so, will be disregarded. Fourth, an economic benefit provided to a disqualified person solely as a member of a charitable class that it is within the organization's exempt purposes to benefit generally will be disregarded.[127]

Revenue Sharing Arrangements

The temporary regulations do not provide any guidance regarding revenue sharing arrangements and that section in the regulations has been reserved. Although the IRS received numerous comments with respect to revenue sharing arrangements, such comments offered a variety of conflicting suggestions. The IRS and the Treasury Department will continue to consider the previously received comments and the preamble indicates that any new revenue-sharing rules would be issued first in proposed form to provide an opportunity for comment. In the meantime, revenue sharing transactions will continue to be evaluated strictly based on fair market value under the general rules defining EBTs set forth at Section 53.4958-4T of the temporary regulations, which rules apply to all transactions with disqualified persons regardless of whether the person's compensation is determined by reference to revenues of the organization.[128] Even before final regulations are issued, revenue sharing arrangements may constitute prohibited private inurement or result in excessive private benefit thus jeopardizing tax-exempt status.[129]

Informal comments from Treasury officials suggest that Treasury and the IRS decided that there was no need at present for a separate test under Section 4958 for revenue sharing arrangements and that "using the same test [of fair market value] provides more certainty because all transactions will be subject to the same standard of reasonableness." In their view, "[n]o revenue-sharing arrangement is per se unreasonable." At the same time, they indicated that Treasury will revisit the need for revenue sharing rules if the single test is inadequate in practice.[130] It is unclear whether Treasury and the IRS would take the same "fair market value only" view of revenue sharing for inurement and private benefit purposes, where there is prior unrevoked guidance on point (e.g., GCM 39862 where the IRS found certain net revenue stream joint ventures with physicians to result in *per se* inurement). The temporary regulations do, however, reiterate that the substantive requirements for exemption, including the inurement prohibition, still apply and may be implicated even where there is no excess benefit.[131]

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127 Temp. Reg. §53.4958-4T(a)(4)(i)-(iv); Prop. Reg. §53.4958-4(a)(3)(ii).

128 66 Fed Reg. at 2153.

129 66 Fed. Reg. at 2153; Temp. Reg. §53.4958-5T; GCM 39862 (Nov. 21, 1991).

130 "Intermediate Sanctions," *supra* (BNA summary of comments of Steven Arkin and Susan Brown).

131 Temp. Reg. §53.4958-8T(a).

If revenue sharing rules are added to the regulations, "excess benefit transactions" may also include any revenue sharing arrangement where the disqualified person is paid based on a percentage of the revenues of the organization or any of its activities where the arrangement results in inurement (i.e., is defectively structured), whether or not total compensation exceeds fair market value. The entire amount of the revenue sharing payment in that case would be a taxable excess benefit. Under the proposed regulations, a defectively structured revenue-sharing arrangement would have been one that allows the disqualified person to receive additional compensation (i.e., the percentage payments) without providing proportional benefits to the organization that contribute to its exempt purposes.[132] As one Treasury Department official phrased it, the question is "whether the arrangement could cause the interests of the organization and disqualified person to diverge."[133] Examples of defectively structured arrangements under the proposed regulations would include giving a disqualified person the equivalent of an equity interest in the exempt organization or allowing the disqualified person to manipulate expenses to increase his or her compensation.

Any new revenue sharing provision would apply to any transactions occurring on or after the date of publication of revenue sharing provisions in the final regulations.[134] The date of occurrence of a transaction generally would be "the date on which the disqualified person receives the economic benefit . . . for federal income tax purposes."[135] Under that definition, any payment made in a prohibited revenue-sharing arrangement after the publication of the final regulations could be viewed as an EBT, even if the arrangement was in place before the regulations are finalized.[136] It remains to be seen whether any grandfathering provision will be included in the final regulations for pre-existing binding contracts. Without a grandfathering provision, many existing whole hospital and ancillary services joint ventures, contracts including any percentage compensation, and a variety of hospital-physician programs, including the so-called "gainsharing" programs, may need to be restructured. Moreover, exempt organizations should note that without further revisions, the rebuttable presumption procedures would not apply to defectively structured revenue-sharing arrangements.

Correcting Excess Benefit Transactions

The second tier (200%) penalty excise tax only applies under Section 4958 if the EBT is not corrected within the taxable period (i.e., prior to the earlier of the date of mailing of a notice of deficiency or the date on which the first tier (25%) tax is assessed). In this regard, correction requires undoing the transaction where possible and taking additional steps to place the exempt organization in at least the same financial position that it would have been in if the disqualified person had dealt with it under the highest fiduciary standards.[137] In the preamble, the IRS confirms that a disqualified person will receive notice of an examination that may lead to penalty

132 Prop. Reg. §53.4958-5.

133 98 TNT 148-7, *supra*; A. Bennett, "Exempt Organizations: Intermediate Sanctions Rules Praised; Regulations Will Not Be Finalized This Year," Daily Tax Report (BNA), G-1 (Aug. 3, 1998).

134 66 Fed Reg. at 2153; Temp. Reg. §53.4958-5T.

135 Temp. Reg. §53.4958-1T(e).

136 See 98 TNT 148-7, *supra*.

137 I.R.C. §4958(b) & (f)(5); Treas. Reg. §53.4958-1T(c)(2)(iii) & -7T(a).

excise taxes in two ways and will receive that notice prior to either event that ends the taxable period. First, Section 7602(c) requires the IRS to notify taxpayers at the start of the examination process that the IRS may be contacting third parties about the taxpayer's tax liabilities. Second, the IRS would issue a first proposed letter of deficiency at least 30 days before a notice of deficiency is issued.[138]

The temporary regulations also significantly expand the guidance afforded by the IRS with respect to correcting EBTs, as evidenced by the addition of Section 53.4958-7T of the temporary regulations, entitled "Correction." By way of example, the temporary regulations provide that an EBT would be "corrected" if the disqualified person repaid an amount equal to the amount of the excess benefit plus interest (the "correction amount") to compensate the exempt organization for the loss of use of the money during the period between receipt and repayment of the excess benefit amount.[139] The amount of the interest charge is determined by multiplying the excess benefit by an interest rate, compounded annually, for the period from the date the EBT occurred to the date of correction. The temporary regulations clarify that the interest rate used for this purpose must equal or exceed the applicable Federal rate ("AFR"), compounded annually, for the month in which the transaction occurred. The period from the date the EBT occurred to the date of correction is used to determine whether the appropriate AFR is the Federal short-term rate (three years or less since the EBT occurred), mid-term rate (three to nine years) or long-term rate (over nine years).[140]

In general, a disqualified person corrects an excess benefit only by making a payment equal to the correction amount in cash or cash equivalents to the organization (excluding promissory notes). If a disqualified person engages in a circumvention scheme to transfer other property, the Commissioner may determine that the disqualified person effectively transferred other property and therefore did not meet the correction requirements. The temporary regulations also include one example of such a circumvention scheme involving a loan to a disqualified person for a promissory note, with the loan and note in the same as a purported cash correction payment made the next day.[141]

Upon the agreement of the exempt organization (in its unfettered discretion without any participation by the disqualified person in the decision), a disqualified person may make a payment by returning specific property previously transferred in the EBT, and the payment will be valued at the lesser of the fair market value of such property on the date it is returned or on the date the EBT occurred. If that amount is less than the correction amount, the disqualified person also <u>must</u> make a cash payment to the organization equal to the difference. Conversely, if the payment made by returning the property exceeds the correction amount, the organization <u>may</u> make a cash payment of the difference to the disqualified person.[142]

Where the EBT involves payment for services under an ongoing employment arrangement or contract, it is not necessarily a requirement that the employment or contract be

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138 66 Fed. Reg. at 2144.

139 Temp. Reg. §53.4958-7T(c).

140 66 Fed Reg. 2145; Temp. Reg. §53.4958-7T(c) & (f).

141 Temp. Reg. §53.4958-7T(b) & (f), *Example 5*.

142 66 Fed Reg. 2145; Temp Reg. §53.4958-7T(b)(4).

terminated. The terms may need to be modified, however, such as by increasing the services and/or decreasing future compensation.[143] The temporary regulations do not specify whether these same modifications will be permitted where the excess benefit arose in a prior contract that was replaced, extended or otherwise materially modified. Other parts of the temporary regulations suggest it would be a new contract and thus the old one would be fully performed and beyond cure by altering the mix of services. Absent some type of circumvention scheme, however, the IRS may be amenable to reasonable arguments that the ongoing contractual relationship is sufficient to allow this manner of correction. It would at least be a worthwhile subject of inquiry or a ruling request.

The temporary regulations also include a special rule allowing a disqualified person to correct at least a portion of an excess benefit resulting from the vesting of benefits provided under a nonqualified deferred compensation plan. Prior to distribution of those benefits, the disqualified person may relinquish any right to receive benefits not yet distributed (including any earnings thereon).[144] The flexibility of this provision could apply to a number of deferred compensation plans in the health care area where, for physicians in particular, substantial benefits often vest well before they are ultimately distributed.

If the transaction is corrected within the correction period, the second-tier 200% tax will be abated and, if the taxpayer establishes that the EBT was due to reasonable cause and not willful neglect, the 25% first tier tax also will be abated.[145] In addition, the temporary regulations clarify that if the disqualified person makes a payment of less than the full correction amount, the 200% tax is imposed only on the unpaid portion of the excess benefit.[146] Finally, the temporary regulations also explicitly provide that a disqualified person must correct an EBT even where an exempt organization has ceased to exist or is no longer exempt under Section 501(c)(3) or (4), making payment to successor 501(c)(3) or (4) organizations (though not from a (c)(3) to a (c)(4)).[147]

<u>Unanswered Questions</u>

The temporary regulations do an admirable job of addressing many areas where guidance was needed under TBOR2, but some questions remain. Two of the most significant unanswered questions from the proposed regulations are (1) the circumstances under which exemption will be revoked instead of or in addition to penalty excise taxes, and (2) the structural parameters of permissible revenue-sharing arrangements. The preamble indicates that the IRS will publish guidance on the relevant factors it will consider in revocation cases "as it gains more experience administering the section 4958 regime."[148] Of course, the IRS and the Treasury Department also intend to continue to evaluate the manner in which to regulate revenue sharing arrangements and would seek comments on any proposed revenue-sharing rules.[149] In the temporary regulations,

143 Temp. Reg. §53.4958-7T.

144 Temp. Reg. §53.4958-7T(b)(3).

145 I.R.C. §§ 4961(a) & 4962(a); 66 Fed. Reg. at 2144-45; Temp. Reg. §53.4958-1T(c)(2)(iii).

146 66 Fed. Reg. at 2145; Temp. Reg. §53.4958-1T(c)(2)(i).

147 Temp. Reg. §53.4958-7T(e).

148 66 Fed. Reg. at 2155.

149 66 Fed. Reg. at 2153.

the IRS asked for new comments on only the potential issues raised by applying the fair market standard of Section 4958 to distributions from a donor-advised fund. Nevertheless, a number of other questions remain open, including:

- Is management authority necessary for a staff physician to be a disqualified person in his/her relationship with a hospital or will admissions or other referrals alone be sufficient factors?
- Will percentage-based compensation be determinative in concluding that the recipient always is a disqualified person, even if the percentage arrangement, though constituting the primary basis for his/her compensation, is tied exclusively to his/her personal productivity?
- Will any rebuttable presumption process and/or grandfathering or a phase-in period apply to prohibited revenue-sharing arrangements (aside from establishing a presumption of fair market value)?
- Will use of a termination penalty such as severance payments for an employee avoid cancellable contracts being treated as new contracts as of the date they could be cancelled?
- Will the IRS accept (and how will it evaluate) community benefit as a consideration in determining the fair market value of payments to disqualified persons?
- Will legal opinions that assume fair market value be sufficient to provide a reasonable cause defense for organization managers?

Conclusion

With the release of the TBOR2 temporary regulations, the IRS has provided some additional guidance with respect to EBTs, even though a number of questions remain unanswered. Following the rebuttable presumption procedure outlined in the regulations may not avoid challenges to arrangements with disqualified persons, but it can put the organization in a better position to defend against those challenges. To take full advantage of that presumption, existing conflicts of interest policies should be revised, if necessary, in light of the conflicts provisions in the temporary regulations. Even without following that procedure, exempt organizations must understand the basic parameters of the IRS view of EBTs and make reasonable efforts to comply, including focusing on the adequacy of detail in the comparable data used to support compensation packages for disqualified persons and documenting the experience of board or committee members or officers reviewing those arrangements (and equivalent attention to asset valuation for acquisitions and leases. Given the continuing uncertainty of the treatment of revenue-sharing arrangements and the potential for more changes in the final regulations, exempt organizations also should build in the ability to reopen and restructure arrangements consistent with the final regulations.

The ongoing challenge to the industry is to utilize this guidance in a sensible manner so as to protect both charitable assets and the individuals whose livelihood derives from managing those assets and providing items and services that assist in carrying out the charitable purposes of the organization. Since the promulgation of the proposed regulations, we have begun to see practical, real-life examples of how inurement is no longer just the exempt organization's problem (e.g., Bishop's Estate, Sta-home Home Health). With the promulgation of these temporary regulations, it is likely that we will see continued and even increased review and enforcement of TBOR2. The release of the temporary regulations has given the industry additional guidance to plan its transactions from a tax perspective and prepare for those enforcement actions. An organization’s preparation and adherence to such guidance will be a key factor in the end result.

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