P-01 3994 11/5/02 12:29 PM Page 1

CHAPTER 1

Basics and History of Intermediate Sanctions Law

The words *intermediate sanctions* strike the uninitiated as discordant and uninformative. Admittedly, their meaning is not self-evident. Despite this initial mystery, intermediate sanctions, even though a relatively new component of the law of tax-exempt organizations, are rapidly becoming one of its most significant elements.

The law of intermediate sanctions represents the most dramatic and important package of federal tax law rules concerning tax-exempt organizations since Congress enacted the basic statutory scheme in this field in 1969. That is, over three decades ago, Congress passed the Tax Reform Act of 1969,[1] which, among its many innovations, included enactment of law splitting the charitable world into public charities and private foundations[2] and imposing stringent rules of operations concerning these foundations.

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[1] Pub. L. No. 91-172, 91st Cong., 1st Sess. (1969); 83 Stat. 487.

[2] A *public charity* is an organization that is tax-exempt for federal income tax purposes, pursuant to Internal Revenue Code of 1986, as amended, section (IRC §) 501(a), because it is organized and operated as a charitable, educational, religious, scientific, or like organization (i.e., is described in IRC § 501(c)(3)), and is (1) an institution, such as a university, hospital, or church, (2) publicly supported, or (3) is a supporting organization; this type of charitable organization is not (by reason of IRC § 509(a)) a private foundation. A *private foundation*, then, is any charitable or like organization that fails to qualify as a public charity. Every organization described in IRC § 501(c)(3) is presumed to be a private foundation (IRC § 508(b)); this presumption can be rebutted by a showing that the entity qualifies as a public charity. See *infra* § 3. In general, Hopkins and Blazek, *Private Foundations: Tax Law and Compliance* (New York: John Wiley & Sons, 1997) (annually supplemented) (*Private Foundations*), particularly Chapter 15.

P-01 3994 11/5/02 12:29 PM Page 2

Much of the motivation for creation of the private foundation rules—fear of considerable abuse—is mirrored in the reasons for adoption of the intermediate sanctions rules. Just as policymakers were fearful of transactions between private foundations and persons close to them, policymakers are now fretting over transactions between public charities and persons close to them. A considerable portion of the structure of the intermediate sanctions rules is reflective of the private foundation rules. The essential difference between the two sets of rules, however, is that private foundation rules generally *forbid* the transactions involved whereas, in the public charity setting, transactions are tested against a standard of *reasonableness*.

Intermediate sanctions have the promise of transforming the private inurement and private benefit doctrines,[3] and are impacting the composition and functioning of many boards of directors (and trustees) of tax-exempt organizations.

§ 1.1 INTERMEDIATE SANCTIONS LAW BASICS

(a) Meaning of Intermediate Sanctions

The purpose of the law of intermediate sanctions[4] is to prevent wrongdoing by persons who have a special relationship with many types of nonprofit, tax-exempt organizations, particularly charitable entities. Before enactment of the intermediate sanctions rules, the Internal Revenue Service,[5] when faced with one of these inappropriate transactions, had essentially two choices:

1. Apply the private inurement doctrine or the private benefit doctrine and revoke the tax-exempt status of the organization.
2. Ignore the matter (or perhaps informally attempt to influence the behavior of the parties involved on a going-forward basis).[6]

[3] See Chapter 2.
[4] IRC § 4958. An executive summary of these rules is in Appendix A. The text of this provision is reproduced as Appendix B.
[5] The Internal Revenue Service is referenced throughout as the IRS.
[6] Occasionally the IRS formally settles with a tax-exempt organization in this regard by means of a closing agreement. Two of the best known of these settlements involved the Bishop Estate and Hermann Hospital. The authority for use of closing agreements is in IRC § 7121.

P-01 3994 11/5/02 12:29 PM Page 3

From the standpoint of the IRS, these options were unsatisfactory. Consequently, the Department of the Treasury and the IRS urged Congress to enact the intermediate sanctions rules.[7]

Revocation of an organization's tax-exempt status is often seen as a harsh punishment.[8] Moreover, loss of tax-exempt status does not resolve the underlying problem—the party that obtained the inappropriate benefit still has it. Often the only individuals truly punished in these situations are the beneficiaries of the organization's programs. Yet doing nothing can be untenable.

Intermediate sanctions are penalties imposed on the person or persons who engaged in the inappropriate transaction with the tax-exempt organization. The sanctions are considered *intermediate* because they are between the choices of revocation of tax-exempt status and inaction on the part of the IRS. Also, the sanctions do not fall on the tax-exempt organization that was abused—they are imposed on the person or persons who improperly benefited from the transaction involved.

This body of law is grounded in private inurement principles, and much of its phraseology is borrowed from the self-dealing rules applicable in the private foundation context.[9]

These sanctions have not replaced either the private inurement doctrine or the private benefit doctrine. The IRS now has a mix of tools and options: It can impose the sanctions alone, it can impose both the sanctions and the private inurement doctrine, or it can find the sanctions do not apply and nonetheless invoke the private benefit doctrine.

According to the IRS fiscal year 2002 Implementing Guidelines,[10] a task force has been established, as a "priority work" item, to develop overall strategy relating to these rules.

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[7] For example, U.S. Department of the Treasury's Proposals to Improve Compliance by Tax-Exempt Organizations: Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means, 103d Cong., 2d Sess. 17 (1994).

[8] For example, the IRS revoked the tax-exempt status of a church because it engaged in political campaign activities; this revocation was upheld in the courts (*Branch Ministries, Inc.* v. *Rossotti*, 40 F. Supp. 2d 15 (D.D.C. 1999), *aff'd*, 211 F.3d 137 (D.C. Cir. 2000)). Over 10 years after this involvement in the 1992 presidential campaign, tax-exempt organization law specialists and others are still fiercely debating whether the IRS should have revoked this exemption, rather than invoking the lesser sanction of payment of the tax on political expenditures (IRC § 4955).

[9] IRC § 4941. See *infra* § 4.

[10] These guidelines, made public early in 2002, outline how the Exempt Organizations component of the IRS will be applying its resources in support of the IRS's major strategies and

(b) Nature of the Sanctions

The sanctions are in the form of federal taxes—they are types of *excise* taxes. The taxes are applied to the amount involved in the impermissible transaction—the *excess benefit*.[11] The person or persons who pay the tax (again, not the exempt organizations involved[12]) are termed *disqualified persons*.[13]

There is an *initial tax*, which is 25 percent of the excess benefit.[14] Also, the transaction must be undone, by placing the parties in the same economic position they were in before the transaction was entered into—this is known as *correction* of the transaction.[15]

If the initial tax is not timely paid and the transaction is not timely and properly corrected, an *additional tax* may have to be paid; this tax is 200 percent of the excess benefit.[16] In some instances, the trustees, directors, or officers with the tax-exempt organization may be required to pay a tax of 10 percent of the excess benefit.[17]

Under certain circumstances, an intermediate sanctions tax can be abated.[18] Generically, these taxes are sometimes referred to as *penalties*.

(c) Fundamental Terminology

Enactment of the intermediate sanctions statute and promulgation of the accompanying tax regulations brought into the law a host of new terms. The principal ones are:

- *Applicable tax-exempt organization.* This term means the types of tax-exempt organizations that are involved in these rules. They are public charities and social welfare organizations.[19]

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operational priorities in the exempt organizations area in the coming months and years. The guidelines are summarized at XIX *The Nonprofit Counsel* (No. 2) 2 (Feb. 2002).

[11] See § 4.1.

[12] As noted, in the event of an excess benefit transaction, it is the disqualified person that is subject to tax, not the exempt organization in the transaction. It is possible, however, for an exempt organization other than a charitable one to be a disqualified person (see § 3.9, text accompanied by notes 59–60).

[13] See Chapter 3.

[14] See § 6.1.

[15] See § 6.2.

[16] See § 6.3.

[17] See § 6.4.

[18] See § 7.3.

[19] See *infra* § 3.

P-01 3994 11/5/02 12:29 PM Page 5

- *Disqualified person.* This term (which is also used in the private foundation setting[20]) refers to the person or persons who have a close relationship with an applicable tax-exempt organization.[21]
- *Excess benefit transaction.* This is the type of transaction that is at the heart of the intermediate sanctions rules. It is an impermissible transaction between an applicable tax-exempt organization and a disqualified person.[22]
- *Excess benefit.* An excess benefit is the impermissible aspect of a transaction that constitutes an excess benefit transaction. It is the amount used to compute one or more intermediate sanctions taxes.
- *Revenue-sharing transaction.* This is a transaction between an applicable tax-exempt organization and a disqualified person, where the benefit flowing to the disqualified person is based, in whole or in part, on the revenue flow of the exempt organization.[23]
- *Initial contract exception.* This is a broad exception to the concept of the excess benefit transaction, by which the transaction created by the initial relationship between an applicable tax-exempt organization and a disqualified person is exempted from the intermediate sanctions penalties.[24]

Other terms used in the intermediate sanctions field are not new but are integral to an understanding of this regulatory scheme:

- *Initial tax.* This is the tax that is initially levied on an excess benefit amount. It is also referred to as a *first-tier tax*.[25]
- *Additional tax.* This is the tax that can be imposed on an excess benefit amount, if the initial tax is not timely paid.[26]
- *Correction.* Correction is the process that is required to undo an excess benefit transaction and return the parties to the economic position they were in before the transaction was entered into.[27]

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[20] IRC § 4946.
[21] See Chapter 3.
[22] See § 4.1.
[23] See § 4.7.
[24] See § 4.4.
[25] See § 6.1.
[26] See § 6.3.
[27] See § 6.2.

P-01 3994 11/5/02 12:29 PM Page 6

- *Abatement.* This is authority accorded the IRS to, in certain circumstances, waive the intermediate sanctions penalties.[28]

§ 1.2 HISTORY OF INTERMEDIATE SANCTIONS

(a) General History

The rules creating these intermediate sanctions were enacted by Congress and signed into law by the president on July 30, 1996.[29] This body of law, which came into existence by enactment of the Taxpayer Bill of Rights 2,[30] has an extensive and somewhat convoluted history.[31]

The intermediate sanctions legislation passed the House of Representatives on April 16, 1996. The Senate adopted the measure on July 11, 1996, without change. The House vote was 425 to 0; the Senate voted by unanimous consent.

The House Committee on Ways and Means produced a committee report to accompany this legislation.[32] The Senate Finance Committee did not prepare a report, and, inasmuch as the Senate adopted the House version of the measure, there was no need for a conference report. Thus, the House Report constitutes the totality of the legislative history of the intermediate sanctions rules.[33]

The IRS, in 1996, provided a brief summary of the intermediate sanctions rules.[34] It published a more extensive treatment of these rules in 2001.[35]

(b) Accompanying Regulations

Nearly all tax statutes are accompanied by regulations promulgated by the IRS and the Department of the Treasury (of which the IRS is a compo-

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[28] See § 7.3.
[29] Pub. L. No. 104-168, 104th Cong., 2d Sess. (1996); 110 Stat. 1452.
[30] This legislation is referred to in this section as the Act. Intermediate sanctions are the subject of § 1311(a) of the Act.
[31] See Appendix D.
[32] H. Rep. 104-506, 104th Cong., 2d Sess. (March 28, 1996) (House Report).
[33] The appropriate portion of the House Report is reproduced as Appendix C.
[34] Notice 96-46, 1996-2 C.B. 112.
[35] The IRS Exempt Organizations Continuing Professional Education Technical Instruction Program book for the government's fiscal year 2002 included, in section II, an essay titled "An Introduction to I.R.C. 4958 (Intermediate Sanctions)" (FY 2002 CPE Book).

P-01 3994 11/5/02 12:29 PM Page 7

nent agency). These regulations explain, and sometimes expand, the law and often provide examples of applicability of the rules. The intermediate sanctions statute is accompanied by tax regulations, although the process for preparing them was more extensive than usual.

On September 12, 1996, the IRS invited comments on the intermediate sanctions rules.[36] Proposed regulations were issued on July 30, 1998[37]—precisely two years after enactment of the statute that created the intermediate sanctions rules. The proposal was officially published for public comment on August 4, 1998.[38] The IRS held a hearing on these rules on March 16 and 17, 1999.

Usually, once regulations have been published in final form and a hearing on them has been had, the IRS issues the regulations in final form. That was not the case, however, with the intermediate sanctions regulations. Rather, on January 9, 2001, the IRS issued—to the surprise of many—temporary regulations.[39] These rules were officially published the next day.[40] (These temporary regulations were to be effective for three years, until January 9, 2004.) Final intermediate sanctions regulations were issued on January 21, 2002[41]—five and a half years after the underlying statute was signed into law.[42]

These tax regulations are extensive and intriguing. Overall, they are well written[43]—at least as far as government regulations are concerned—

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[36] Notice 96-46, *supra* note 34.

[37] REG-246256-96 (Prop. Reg.).

[38] 63 Fed. Reg. 41486.

[39] T.D. 8920 (Temp. Reg.).

[40] 66 Fed. Reg. 2144.

[41] T.D. 8978 (Reg.). Other federal tax regulations are also referenced throughout as Reg.

[42] A commentator observed, at the time of issuance of the temporary regulations, that by making the regulations temporary (rather than final), the IRS acknowledged that "it will be necessary to revisit the issues after the Service and the exempt organizations community have had three more years of experience with the relatively new provisions" (Faber, "Comments on the IRS's Temporary Regulations on Intermediate Sanctions," 31 *Exempt Org. Tax Rev.* (No. 2) 163 (Feb. 2001) (Faber I)). Obviously, the IRS decided that three years of experience was not necessary to proceed to final regulations.

[43] Here are two minor, picky comments about the regulations as literature. One pertains to a redundancy. In the regulation providing that a person can be a disqualified person because the person manages a discrete component of an applicable tax-exempt organization (see § 3.5(a)), this type of person is described as one who "manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, *as compared to the organization as a whole*" (Reg. § 53.4958-3(e)(2)(v)) (emphasis

P-01 3994 11/5/02 12:29 PM Page 8

and provide valuable guidance. As far as they go, they are an excellent product—and they improved considerably as they evolved from proposed to temporary to final. One commentator observed that the Department of the Treasury and the IRS did an "outstanding job in developing workable rules for administering an often imprecise statute" and that the "drafters should be commended for producing an excellent and useful body of regulations that will provide needed guidance to both the Service in its administration of the statute and to exempt organizations and their employees and advisors in complying with it."[44]

A curious aspect of these regulations, however, is that they are silent with respect to huge chunks of the intermediate sanctions law. For example, most court cases in this area turn on the valuation of services[45] or property[46]—yet the regulations barely speak to the point.[47] They are silent on the criteria for evaluating the reasonableness of loans, rental arrangements, and asset sales.[48] Nothing is said about transactions for the use of disqualified persons.[49] Attempts are made, through this book, to close those gaps.

(c) Effective Dates

The intermediate sanctions rules generally are effective with respect to excess benefit transactions occurring on or after September 14, 1995.[50] These

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added). The italicized words are redundant, being encompassed by the words *substantial portion of the . . . organization*. This redundancy is repeated in Reg. § 53.4958-3(g), Example 5.

The other comment concerns four examples of persons who are considered to not be disqualified persons (Reg. § 53.4958-3(g), Examples 1, 3, 9, and 10). Yet in each instance, the example points out that these persons are not related to "any other disqualified person." The words *other* should not be there.

[44] Faber, "Final Intermediate Sanctions Regulations Solve Some Problems But Not Others," 35 *Exempt Org. Tax Rev*. (No. 3) 295 (Mar. 2002) (Faber II).

[45] The first of the intermediate sanctions cases filed involved the valuation of services (*Peters* v. *Commissioner*, petition filed in the U.S. Tax Court on August 3, 2000, Docket No. 8446-00 (settled)).

[46] The first of the intermediate sanctions to be decided by a court involved the valuation of property; the bulk of the court opinion is devoted to that issue of fact (*Caracci* v. *Commissioner*, 118 T.C. 379 (2002)).

[47] See § 4.5.

[48] See § 4.7.

[49] See § 4.8.

[50] Act § 1311(d)(1); Reg. § 53.4958-1(f)(1).

P-01 3994 11/5/02 12:29 PM Page 9

rules, then, were made retroactive (to the date the Ways and Means Committee announced they were being written).

These sanctions, therefore, generally do not apply to any excess benefits arising out of a transaction pursuant to a written contract that was binding on September 13, 1995, and that continued in force through the time of the transaction. (This is informally known as the *binding contract exception*.) A written binding contract that is terminable or subject to cancellation by the applicable tax-exempt organization without the consent of the disqualified person (including as the result of a breach of contract by the disqualified person) and without substantial penalty to the organization is no longer treated as a binding contract as of the earliest date that any such termination or cancellation, if made, would be effective. If, however, after September 13, 1995, the terms of the binding written contract have been materially changed, the contract is treated as a new contract that was entered into as of the effective date of the material change. In that event, an excise benefit transaction that occurred[51] under this new contract would be subject to the intermediate sanctions rules.[52]

A *material change* includes an extension or renewal of the contract (other than an extension or renewal that results from the person contracting with the applicable tax-exempt organization unilaterally exercising an option expressly granted by the contract) or a more-than-incidental change to any payment under the contract.[53]

In the first of the intermediate sanctions cases to be the subject of a court opinion, which concerned the transfers of assets of three applicable tax-exempt organizations to three for-profit disqualified person corporations, the effective date of the transfers was October 1, 1995—a mere two weeks after the intermediate sanctions rules took effect.[54] The audit period for the first of the intermediate sanctions cases concerning the reasonableness of an individual's compensation to be filed was calendar years 1995 to 1999;

[51] See § 6.5(h).
[52] Act § 1311(d)(2); Reg. § 53.4958-1(f)(2).
[53] Reg. § 53.4958-1(f)(2).
[54] *Caracci* v. *Commissioner*, *supra* note 46. Some effort was made at trial to assert that the transfers occurred before the intermediate sanctions effective date but that argument was not briefed and the Tax Court deemed it abandoned (as stated in note 12 of the opinion).

thus, the penalties as to the first of these years were calculated only as of September 14, 1995, forward.[55]

Parties to transactions entered into after September 13, 1995, and before January 1, 1997, were entitled to rely on the rebuttable presumption of reasonableness[56] if, within a reasonable period (e.g., 90 days) after entering into the compensation package, the parties satisfied the criteria that gave rise to the presumption. After December 31, 1996, the rebuttable presumption arises only if the criteria are satisfied prior to payment of the compensation (or, to the extent provided by tax regulations, within a reasonable period thereafter).[57]

§ 1.3 APPLICABLE TAX-EXEMPT ORGANIZATIONS

The intermediate sanctions rules apply with respect to public charities[58] and tax-exempt social welfare organizations.[59] For purposes of this definition, any excess benefit involved is disregarded (inasmuch as it would preclude exemption under private inurement principles).[60] These entities are termed, for this purpose, *applicable tax-exempt organizations*.[61]

Applicable tax-exempt organizations include any organization described in either of these two categories of tax-exempt organizations at any time during the five-year period ending on the date of the transaction.[62]

Public charities can be:

- Churches, integrated auxiliaries of churches, and associations and conventions of churches[63]
- Colleges, universities, and schools[64]

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[55] *Peters* v. *Commissioner*, *supra* note 45. See § 4.6(b)(v).

[56] See Chapter 5.

[57] House Report at 60.

[58] See *supra* note 2.

[59] Reg. § 53.4958-2(a)(1). A *social welfare organization* is an organization that is tax-exempt for federal income tax purposes (IRC § 501(a)) because it is described in IRC § 501(c)(4). Tax-exempt social welfare organizations are the subject of Chapter 12 of Hopkins, *The Law of Tax-Exempt Organizations, Seventh Edition* (New York: John Wiley & Sons, 1998) (annually supplemented) (*Tax-Exempt Organizations*).

[60] Reg. § 53.4958-2(a)(1).

[61] I RC § 4958(e)(1).

[62] IRC § 4958(e)(2); Reg. § 53.4958-2(a)(1).

[63] IRC §§ 170(b)(1)(A)(i) and 509(a)(1).

[64] IRC §§ 170(b)(1)(A)(ii) and 509(a)(1).

P-01 3994 11/5/02 12:29 PM Page 11

- Hospitals, other providers of healthcare, and medical research organizations[65]
- Foundations supportive of governmentally operated colleges and universities[66]
- Units of government[67]
- Publicly supported charitable, educational, religious, scientific, and like organizations[68]
- Organizations that are supportive of other public charities[69]

Tax-exempt social welfare organizations[70] include entities that are civic in nature, assist a community in various ways, and/or engage in more advocacy (usually lobbying) than is allowed for charitable organizations.

Thus, an entity is an applicable tax-exempt organization if it was either type of tax-exempt organization at any time in the five-year period before the excess benefit transaction occurred. This rule is known as the *lookback rule*, and this five-year period is known as the *lookback period*.[71]

There are no exemptions from these rules (e.g., for small organizations[72] or religious entities[73]) for U.S. entities. All domestic public charities and all social welfare organizations are applicable tax-exempt organizations.[74] A foreign organization that is tax exempt, by determination of the IRS or by

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[65] IRC §§ 170(b)(1)(A)(iii) and 509(a)(1).
[66] IRC §§ 170(b)(1)(A)(iv) and 509(a)(1).
[67] IRC §§ 170(b)(1)(A)(v) and 509(a)(1).
[68] IRC §§ 170(b)(1)(A)(vi) and 509(a)(1), and 509(a)(2).
[69] IRC § 509(a)(3).
[70] See *supra* note 58.
[71] Reg. § 53.4958-2(a)(1). Because of the intermediate sanctions effective date (see *supra* § 1.2(c)), in the case of an excess benefit transaction occurring before September 14, 2000, the lookback period begins on September 14, 1995, and ends on the date of the transaction (Reg. § 53.4958-2(b)(1)).
[72] E.g., an organization that normally has annual gross revenue not in excess of $5,000 is not required to file an application for recognition of tax exemption (IRC § 508(c)(1)(B)), and one that normally has gross revenue not in excess of $25,000 is not required to file an annual information return (IRC § 6033(a)(2)(B)).
[73] E.g., churches and certain other religious organizations are not required to file an application for recognition of tax exemption (IRC § 508(c)(1)(A)) and are not required to file annual information returns (IRC § 6033(a)(2)(A)(i)).
[74] Private foundations (see *supra* note 2) are not included in this tax regime because a somewhat similar system—involving self-dealing rules (IRC § 4941)—is applicable to them (Reg. § 53.4958-2(a)(2)(i)). The self-dealing rules are the subject of Chapter 5 of *Private Foundations*.

P-01 3994 11/5/02 12:29 PM Page 12

treaty, as a charitable or social welfare entity is not an applicable tax-exempt organization if it receives substantially all of its support from sources outside the United States.[75]

The definition of the term *applicable tax-exempt organization* encompasses the concept of *recognition* of tax-exempt status. Most categories of tax-exempt organizations are tax exempt because they satisfy one or more federal tax law definitions of the term. Some organizations, however, to be tax exempt, must file notice with the IRS to that effect and have their exempt status recognized by the IRS. This recognition is accomplished by the issuance of a determination letter or ruling.

Generally, for an organization to be a tax-exempt charitable organization, it must file a notice with, and have its tax-exempt status recognized by, the IRS.[76] Some charitable organizations, such as churches and certain other religious organizations and small organizations, are exempt from the requirement of recognition.[77] For a charitable organization to be an applicable tax-exempt organization, it must be in compliance with the recognition requirements.[78]

Social welfare organizations, to be tax exempt, need not (although they may) have their exempt status recognized by the IRS. An organization can be an applicable tax-exempt organization by reason of being an exempt social welfare organization in four ways:

1. The organization has applied for and received recognition from the IRS as an exempt social welfare organization.[79]
2. The organization has filed an application for recognition with the IRS, seeking exempt social welfare status.
3. The organization has filed an annual information return as an exempt social welfare organization.[80]

[75] Reg. § 53.4958-2(b)(2).
[76] IRC § 508(a). This recognition is applied for by means of Form 1023.
[77] IRC § 508(c).
[78] Reg. § 53.4958-2(a)(3).
[79] Reg. § 53.4958-2(a)(4)(i). This recognition is applied for by means of Form 1024.
[80] There is a perplexing and troubling anomaly here. As this rule indicates, the requirement of recognition of tax-exempt status and the requirement that an organization file an annual information return (IRC § 6033(a)) are separate. That is, simply because an organization is not mandated to file an application for recognition of tax exemption does not mean that it is excused from filing an annual information return (usually Form 990). Thus, most exempt social welfare

P-01 3994 11/5/02 12:29 PM Page 13

4. The organization has otherwise held itself out as an exempt social welfare organization.[81]

An organization is not considered to be an exempt charitable or social welfare organization during any period covered by a final determination or adjudication that the organization is not exempt from tax by reason of either category, as long as that determination or adjudication is not based on a participation in a private inurement transaction[82] or an excess benefit transaction.[83] Nonetheless, an organization in this situation may be an applicable tax-exempt organization for that period as a result of the lookback rule.[84]

A governmental unit or an affiliate of a governmental unit is not an applicable tax-exempt organization if it is (1) exempt from or not subject to taxation without regard to the general statutory basis for tax exemption[85] or (2) relieved from the requirement of filing an annual information return.[86] A governmental entity may be exempt as an integral part of the state, by reason of the doctrine of intergovernmental immunity, or because its income is excluded from federal taxation.[87]

Nonetheless, the scope of this exception for governmental entities is not entirely clear. According to unpublished IRS policy, a governmental entity that is exempt on a basis other than the statutory exemption and that has been recognized by the IRS as a tax-exempt organization pursuant to

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organizations are required to file an annual information return, even if their tax exemption has not been recognized by the IRS. Yet it is the policy of the IRS that, if a social welfare organization or other similarly situated organization files an annual information return, but has not sought recognition of tax-exempt status, the annual information return will be rejected and the organization must commence filing of tax returns (INFO 2000-0260). Also Priv. Ltr. Rul. 200217044 (where an organization was not treated as having engaged in taxable transfers of its assets (IRC § 337(d)) due to an exception; the IRS required the organization to file an application for recognition of exemption even though it was not required by law to do so). The position of the IRS is that the statute concerning the filing of annual information returns (IRC § 6033) mandates the organizations to prepare and submit them but it does not require the IRS to accept them!

[81] Reg. § 53.4958-2(a)(4)(ii).

[82] See *infra* § 4 and Chapter 2.

[83] Reg. § 53.4958-2(a)(5). Essentially, this pertains to an organization that never achieved recognition of tax-exempt status or had exempt status revoked.

[84] See the text accompanied by *supra* note 71.

[85] IRC § 501(a).

[86] Reg. § 53.4958-2(a)(2)(ii).

[87] IRC § 115.

P-01 3994 11/5/02 12:29 PM Page 14

the statutory rule is obligated to comply with the requirements imposed on the latter for other law purposes (e.g., filing annual information returns and compliance with the unrelated business rules). For example, a state university or a city hospital may have secured recognition of tax exemption as an educational or charitable organization.[88] Often this is done to attract charitable contributions and grants from funding sources that lack confidence that governmental entities are charitable organizations for this purpose.[89] In these circumstances, the IRS usually requires the charitable or educational entity to comply with the law requirements to which other organizations that have the statutory exemption must adhere. Thus, it is not known whether a governmental entity that also has recognition from the IRS as a charitable organization or social welfare organization is an applicable tax-exempt organization. The better view is that a governmental organization in this position is not an applicable tax-exemption organization, in that it is exempt *without regard to* the statutory exemption. Of course, a governmental entity that does not have the statutory recognition of exemption is not an applicable tax-exempt organization.

This matter is somewhat clarified by the second prong of the exception, pertaining to organizations that do not have to file annual information returns. Some organizations are not required to file these returns where the filing is deemed by the IRS to be unnecessary to the efficient administration of the internal revenue laws.[90] The IRS has exercised its authority in this regard to provide an exemption for governmental units and their affiliates—and the intermediate sanctions regulations tap into this aspect of the law.

An entity is a *governmental unit* if it is:

- A state or local governmental unit as defined in the rules providing an exclusion from gross income for interest earned on bonds issued by these units[91]
- Entitled to receive deductible charitable contributions as a unit of government[92]

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[88] I.e., as an organization described in IRC § 501(c)(3).
[89] See IRC § 170(b)(1)(A)(v), (c).
[90] IRC § 6033(a)(2)(B); Reg. § 1.6033-2(g)(3).
[91] IRC § 103; Reg. § 1.103-1(b).
[92] IRC § 170(c)(1).

P-01 3994 11/5/02 12:29 PM Page 15

- An Indian tribal government or a political subdivision of this type of government[93]

An entity is an *affiliate of a governmental unit* if it is a tax-exempt organization[94] and meets one of two sets of requirements. One is that it has a ruling or a determination letter from the IRS that:

- The organization's income, derived from activities constituting the basis for its exemption, is excluded from gross income under the rules for political subdivisions and the like[95]
- It is entitled to receive deductible charitable contributions on the basis that contributions to it are for the use of governmental units.[96]
- It is a wholly owned instrumentality of a state or political subdivision of a state for employment tax purposes.[97]

The other set of requirements is available for an entity that does not have a ruling or determination letter from the IRS but:

- It is operated, supervised, or controlled by governmental units or by organizations that are affiliates of governmental units, or the members of the organization's governing body are elected by the public, pursuant to local statute or ordinance.
- It possesses two or more of certain affiliation factors.[98]
- Its filing of an annual information return is not otherwise necessary to the efficient administration of the internal revenue laws.[99]

An organization can, but is not required to, request a ruling or a determination letter from the IRS that it is an affiliate of a governmental unit.

The following, then, also are not applicable tax-exempt organizations:

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[93] IRC §§ 7701(a)(40), 7871. This tripartite definition of *governmental unit* is in Rev. Proc. 95-48, 1995-2 C.B. 418 § 4.01.
[94] I.e., described in IRC § 501(c).
[95] IRC § 115. See the text accompanied by *supra* note 86.
[96] IRC § 170(c)(1). See the text accompanied by *supra* note 91.
[97] IRC §§ 3121(b)(7), 3306(c)(7). This tripartite definition is provided by Rev. Proc. 95-48, *supra* note 93.
[98] Rev. Proc. 95-48, *supra* note 93 § 4.03.
[99] *Id.* § 4.02(b).

P-01 3994 11/5/02 12:29 PM Page 16

- Private foundations[100]
- Governmental entities and their affiliates
- Tax-exempt organizations that are not recognized as charitable or social welfare organizations[101]

§ 1.4 INTERRELATIONSHIP WITH OTHER LAW

The intermediate sanctions rules have a direct and substantive relationship with other and with preexisting bodies of federal tax law. Generally, there are three other sets of laws in this regard, all of which are designed to achieve the same objective: prevent persons who have a close relationship with a charitable organization from manipulating the flow or income or assets to them or otherwise for their private benefit:

1. Private inurement doctrine
2. Private benefit doctrine
3. Self-dealing rules

The *private inurement doctrine* runs parallel to the intermediate sanctions rules. In many ways, these rules are a codification of the private inurement doctrine. The concepts of *private inurement* and *excess benefit transaction* are essentially identical. The same is true with respect to the concepts of *insider* and *disqualified person*. In the case of the private inurement doctrine, the sanction is revocation of tax-exempt status. The IRS can apply the private inurement doctrine in lieu of the intermediate sanctions penalties or in addition to these penalties.[102]

The *private benefit doctrine* is applicable only to charitable organizations; that is, it is not applicable to other types of tax-exempt organizations, including social welfare organizations. It is applicable to both public charities and private foundations.[103] In many ways, the concepts of private benefit

[100] See *supra* note 73.

[101] Thus, entities such as business leagues (IRC § 501(c)(6) organizations), social clubs (IRC § 501(c)(7) organizations), and many other types of tax-exempt organizations, which may have operating relationships with IRC § 501(c)(3) organizations or IRC § 501(c)(4) organizations, are not applicable tax-exempt organizations. They may, however, constitute disqualified persons with respect to one or more IRC § 501(c)(3) organizations or IRC § 501(c)(4) organizations.

[102] See § 2.1.

[103] The private benefit doctrine is, in practice, rarely applied to private foundations. Indeed, the only known published example of this appears in Priv. Ltr. Rul. 200114040.

P-01 3994 11/5/02 12:29 PM Page 17

and private inurement are the same. Certainly everything that is private inurement is simultaneously private benefit.[104] The sanction, too, is the same: revocation of tax-exempt status. The two principal differences between the doctrines is that a private benefit transaction does not require an insider and that the law recognizes the idea of incidental private benefit. The private benefit doctrine thus can apply even where the private inurement doctrine and/or the intermediate sanctions penalties cannot.[105]

The rules concerning *self-dealing*[106] and the intermediate sanctions rules do not overlap. This is because rules concerning self-dealing apply to charitable organizations only with respect to private foundations, while intermediate sanctions rules apply only with respect to public charities.[107] Nonetheless, the self-dealing rules are significant in the intermediate sanctions setting, in that the intermediate sanctions rules are patterned largely on the private foundation rules. Therefore, a development in the law in the self-dealing context is likely to have a direct impact on development of the intermediate sanctions rules.

The converse is also true. Now that the intermediate sanctions regulations have been issued in final form, the IRS is contemplating one or more amendments to the self-dealing rules that would reflect features of the intermediate sanctions rules. The only change publicly being considered is expansion of the law concerning reliance on the opinions of professional experts.[108] (This matter concerns the tax on organization managers[109] and the tax on foundation managers,[110] both of which can be avoided in cases in which the manager relies on professional advice. The self-dealing rules, however, generally confine this reliance to that on advice in the form of reasoned opinions from lawyers.[111] The intermediate sanctions rules expand that reliance to the opinion of accountants and compensation specialists.[112]) Other features of the intermediate sanctions rules that could be

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[104] E.g., *American Campaign Academy* v. *Commissioner*, 92 T.C. 1053 (1989).
[105] See § 2.2.
[106] See *supra* note 73.
[107] *Id.*
[108] Ann. 2002-47, 2002-18 I.R.B. 844.
[109] IRC § 4958(a)(2). See § 6.5.
[110] IRC § 4941(a)(2), (b)(2).
[111] Reg. §§ 53.4941(a)-1(b)(6), 53.4944-1(b)(2)(v), 53.4945-1(a)(2)(vi). Cf. Reg. § 53.4944-1(b)(2)(v) (where a foundation manager can rely on the advice of qualified investment counsel).
[112] See § 6.5(f).

P-01 3994 11/5/02 12:29 PM Page 18

appended to the private foundation rules include the rebuttable presumption of reasonableness[113] and the initial contract exception.[114]

Indeed, the unique state of the law today is that a development in any one of these four sets of laws is likely to trigger a development in the law in all of the other three areas. For example, a finding by the IRS that a transaction is a private inurement transaction is almost certain to mean that the transaction would (if it involved an applicable tax-exempt organization and a disqualified person) constitute an excess benefit transaction. Likewise, a finding by a court that a transaction is a self-dealing transaction would likely mean that, in the intermediate sanctions context, the transaction would be an excess benefit transaction.

This phenomenon requires lawyers and others who advise in this area to closely track the myriad developments unfolding in all four of these areas of the law. That is a challenge.[115]

§ 1.5 COMMENTARY ON INTERMEDIATE SANCTIONS

On balance, the intermediate sanctions rules embody a good idea; they are a welcome addition to the law of tax-exempt organizations. They place the sanction—the penalties—where it should be: on the persons who inappropriately extracted a benefit from charitable and social welfare organizations, rather than directly on these organizations. The rules—based on a standard of reasonableness—are an improvement over the unnecessarily stringent private foundation rules, which essentially prohibit transactions with foundations and disqualified persons with respect to them.

Yet in the modern era, the intermediate sanctions rules seem somehow paternalistic. Charitable and other tax-exempt organizations are struggling to be better managed and operated; they require competent—preferably talented—employees and advisors, who deserve fair compensation for their services. Many times a person must choose whether to work for a nonprofit or a for-profit entity.

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[113] See Chapter 5.

[114] See § 4.4.

[115] Appendix E presents a list of the frequently asked questions about the intermediate sanctions rules. Appendix F summarizes the process followed by the IRS in analyzing an intermediate sanctions case.

P-01 3994 11/5/02 12:29 PM Page 19

What is the talented executive to do? Take the position with the for-profit corporation, with the handsome salary and other benefits package? Or take the position with the charitable organization, wondering if one day an IRS agent will come along and impose a hefty tax because of ostensibly excessive compensation?

The fundamental flaw in the intermediate sanctions regime is that the penalties can be imposed on persons who acted in good faith. The tax on organization managers can be imposed only if there was a knowing participation in the excess benefit transaction,[116] but otherwise the taxes can be levied even though the person taxed, or potentially taxed, had no idea that he, she, or it did anything inappropriate. A competent executive may well choose to not be placed in that position, to the obvious detriment of the nonprofit organization that could have benefited from his or her services. Some of these problems can be averted by the initial contract exception,[117] the possibility of tax abatement,[118] the rebuttable presumption of reasonableness,[119] and the like. But one still has to go through the process.

Today too many politicians (with emphasis on members of Congress and attorneys general) and other policymakers are quick to assert that executives of charitable organizations are overpaid. (The fact is, across the board, they are underpaid.) Laws like the intermediate sanctions rules are a product of this thinking. The nation's nonprofit sector needs all the competence it can muster, and it is sad to see laws emerge that stifle this progress.

One thing is certain: Lawyers are going to benefit from the enactment of the intermediate sanctions law. Unfortunately, in our society often when lawyers benefit, most others do not.

[116] See § 6.5(d), (e).
[117] See § 6.6.
[118] See § 4.4.
[119] See Chapter 5.