CHAPTER 1

Intermediate Sanctions

The federal tax law includes the much-heralded concept of *intermediate sanctions*—an emphasis on the taxation of those persons who engaged in impermissible private transactions with tax-exempt public charities (and social welfare organizations), rather than revocation of the tax exemption of these entities. With this approach, tax sanctions—structured as penalty excise taxes—may be imposed on the disqualified persons who improperly benefited from the transaction and on organization managers who participated in the transaction knowing that it was improper. This body of law represents the most dramatic and important package of rules concerning exempt charitable organizations since Congress enacted the basic statutory scheme in this field in 1969.

Intermediate sanctions have the promise of transforming the private inurement and private benefit doctrines, and are likely to impact the composition and functioning of many boards of directors.

These rules also have particular significance in the fund-raising setting, both for the charitable organization that solicits contributions and the professional fund-raiser who serves charity in that manner.

Here are the questions professional fund-raisers most frequently ask (or should ask) about the intermediate sanctions rules—and the corresponding answers.

Q 1:1 What does the term *intermediate sanctions* mean?

Before answering, a little background is in order. Prior to enactment of the intermediate sanctions rules, the IRS had only two formal options when it found a substantial violation of the law of tax-exempt organizations by a public charity[1] (or a social welfare organization[2]): do nothing or revoke the organization's tax exemption. The IRS was usually reluctant to do the latter and often anxious about the former.

These intermediate sanctions rules, however, provide the IRS with a third alternative—one that is more potent than doing nothing (including, perhaps, issuing some informal warning) and less draconian than revocation of tax exemption. It is, thus, an *intermediate* sanction.

In the instance of a transaction covered by these rules (Q 1:8), tax sanctions are to be imposed on the disqualified persons (Q 1:18) who improperly benefited from the transaction and perhaps on organization managers (Q 1:30) who participated in the transaction knowing that it was improper.

Another sanction of the "informal" variety is use of the closing agreement (Q 10:16). This recently happened in the Bishop Estate Kamehameha Schools case, although the agreement preserved the organization's tax-exempt status.[3] It does not pertain directly to the intermediate sanctions rules.

Q 1:2 What is the effective date of the intermediate sanctions rules?

The effective date of these rules generally is September 14, 1995.[4] The sanctions do not apply, however, to any benefits arising out of a transaction pursuant to a written contract which was binding on that date and continued in force through the time of the transaction, and the terms of which have not materially changed.[5]

Parties to transactions entered into after September 13, 1995, and before January 1, 1997, were entitled to rely on the rebuttable presumption of reasonableness as to compensation (Q 1:16) if, within a reasonable period (such as 90 days) after entering into the compensation package, the parties satisfied the criteria that gave rise to the presumption. Since December 31, 1996, the rebuttable presumption can arise 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).

Q 1:3 When were these rules enacted?

The intermediate sanctions law came into being on enactment of the Taxpayer Bill of Rights 2 (Act). This legislation was signed into law on

July 30, 1996.[6] Thus, the legislation was made effective retroactively (Q 1:2).

Q 1:4 What is the legislative history of this legislation?

The Senate, on July 11, 1996, adopted the legislation as passed by the House of Representatives, on April 16, 1996, without change. The House vote was 425-0; the Senate voted by unanimous consent. There is no report of the Senate Finance Committee and no conference report. Thus, the report of the House Committee on Ways and Means, dated March 28, 1996 (House Report),[7] constitutes the totality of the legislative history of the intermediate sanctions rules.

Q 1:5 Have the Treasury Department and the IRS issued guidance as to these rules?

Yes, although the guidance is in proposed form as of mid-2000. Proposed regulations were issued on July 30, 1998[8]—precisely on the second anniversary of the signing into law of the intermediate sanctions legislation (Q 1:3). Hearings before the IRS on these proposed regulations were held on March 16-17, 1999.

COMMENT: The proposed regulations are not nearly as helpful as was hoped. For the most part, they merely restate what is in the statute and the legislative history, or can be found in the self-dealing rules in the private foundations context.[9] Most of the new concepts, and nearly all of the proposed law specifically pertaining to fundraising (Q 1:10), are embedded in the examples. Some areas of this body of law where guidance would be appropriate are completely unaddressed by the proposed regulations, such as the criteria for determining whether sales, lending, and rental transactions are reasonable (Q 1:16–Q 1:18). Guidance as to whether compensation is reasonable is skimpy (Q 1:11). Indeed, in one instance, the proposed regulations are in conflict with the legislative history (Q 1:24). Moreover, the case can be made that, in some respects, the proposed regulations overreach the bounds of the statute and legislative history (Q 1:38).

Q 1:6 Are charitable organizations involved in these rules?

Yes. In fact they are the principal types of organizations affected by these rules. These sanctions apply with respect to public charities[10] and

tax-exempt social welfare organizations.[11] These entities are termed, for this purpose, *applicable tax-exempt organizations*.[12]

These entities include any organization described in either of these two categories of exempt organizations at any time during the five-year period ending on the date of the transaction.[13]

NOTE 1: In a case of a transaction occurring before September 14, 2000, the lookback period begins on September 14, 1995, and ends on the date of the transaction.[14]

CAUTION 1: This is one aspect of the intermediate sanctions law that should be closely monitored. There is discussion about broadening the concept of applicable tax-exempt organization. The most likely candidates for inclusion are tax-exempt labor organizations and/or business, professional, and trade associations and other business leagues.[15]

CAUTION 2: Just because an organization is not an *applicable tax-exempt organization* does not mean that it is not caught up in these rules, because an exempt organization can be a disqualified person (Q 1: 30).

NOTE 2: It is not clear as to whether, or the extent to which, governmental entities (such as schools, colleges, and hospitals) may be covered by these rules.

Q 1:7 Are there any exceptions to these rules?

No. That is, all public charities (and social welfare organizations) are applicable tax-exempt organizations. Private foundations[16] are not included in this tax regime because a somewhat similar system, involving self-dealing rules,[17] is applicable to them. Also, a foreign organization that receives substantially all of its support from sources outside the United States is not an applicable tax-exempt organization.[18]

Q 1:8 To what types of transactions do these rules apply?

This tax scheme has as its heart the *excess benefit transaction*. The definition of an *excess benefit transaction* is based on the contract law concept of *consideration*. It generally is any transaction in which an economic benefit is provided by an applicable tax-exempt organization (Q 1:6) directly or indirectly to or for the use of any disqualified person

(Q 1:23), if the value of the economic benefit provided by the exempt organization exceeds the value of the consideration (including the performance of services) received for providing the benefit.[19] This type of benefit is known as an *excess benefit*.[20]

The phrase *excess benefit transaction* also includes a *revenue-sharing transaction* (Q 1:15).

Q 1:9 How is *value* measured?

The standard is that of *fair market value*. The fair market value of property, including the right to use property, is the price at which the property or the right to use it would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell, or transfer the property or the right to use it, and both having reasonable knowledge of the relevant facts.[21] (See Chapter 2.)

Q 1:10 Can an economic benefit be treated as part of the recipient's compensation?

Yes, but with some qualifications. An economic benefit may not be treated as consideration for the performance of services unless the organization clearly intended and made the payments as compensation for services.[22]

NOTE: The legislative history of these rules states that the organization's intent in this regard be *clear*. The proposed regulations, however, require that the intent be *clear and convincing*.[23]

Items of this nature include the payment of personal expenses, transfers to or for the benefit of disqualified persons, and non-fair-market-value transactions benefiting these persons.

In determining whether payments or transactions of this nature are in fact forms of compensation, the relevant factors include whether:

1. The appropriate decision-making body approved the transfer as compensation in accordance with established procedures, and
2. The organization and the recipient reported the transfer (other than in the case of nontaxable fringe benefits) as compensation on relevant returns or other forms.

These returns or forms include the organization's annual information return filed with the IRS,[24] the information return provided by the organization to the recipient (Form W-2 or Form 1099), and the individual's income tax return (Form 1040).[25]

With the exception of nontaxable fringe benefits and certain other types of nontaxable transfers (such as employer-provided health benefits and contributions to qualified pension plans), an organization is not permitted to demonstrate at the time of an IRS audit that it intended to treat economic benefits provided to a disqualified person as compensation for services merely by claiming that the benefits may be viewed as part of the disqualified person's total compensation package.[26] Rather, the organization is required to provide substantiation that is contemporaneous with the transfer of the economic benefits at issue.

Q 1:11 In the context of compensation, how does one determine whether it is excessive?

Existing tax law standards (including those standards established under the law concerning ordinary and necessary business expenses) apply in determining reasonableness of compensation and fair market value.[27]

TIP: In this regard, an individual need not necessarily accept reduced compensation merely because he or she renders services to a tax-exempt, as opposed to a taxable, organization.[28]

Compensation that is excessive is a form of excess benefit transaction; the portion that is considered excessive is an excess benefit.

Q 1:12 What are the tax law standards used in determining the reasonableness of compensation?

The criteria that have been fashioned to determine the reasonableness of compensation are the following:

1. Compensation levels paid by similarly situated organizations, both tax-exempt and taxable, for functionally comparable positions.

2. The location of the organization, including the availability of similar specialties in the geographic area.
3. Written offers from similar institutions competing for the services of the individual involved.
4. The background (including experience and education) of the individual involved.
5. The need of the organization for the services of a particular individual.
6. The amount of time an individual devotes to the position.

An additional criterion that intermediate sanctions have brought to this area of the law is whether the compensation was approved by an independent board.

This is known as the *multi-factor test*. Historically, this test has also been used to assess the reasonableness of compensation paid in the for-profit context. That may be changing, however, with some courts using an *independent investor test* in the for-profit setting.[29] One of the key reasons for this change of standard is a growing realization that judges are usually not competent (by training or experience) to be appraisers of compensation packages or property—the value of an item of compensation or property being a question of fact, not law.

COMMENT: The intermediate sanctions proposed regulations merely extend this guidance: "Compensation 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."[30] Given the immense focus on compensation in relation to the excess benefit transaction standard (and private inurement),[31] this meager offering in the regulations is irresponsible.

The proposed regulations offer some interesting rules as to what *circumstances* are to be taken into account in determining reasonableness, particularly in terms of moments in time. The general rule is that the circumstances to be taken into consideration are those existing at the date when the contract for services is made. Where reasonableness of compensation cannot be determined under those circumstances, however, the determination is to be made based on all facts and circumstances, up to and including circumstances as of the date of payment. Here is the best rule of all in this regard: In no event shall circumstances existing at the date when the

contract is questioned be considered in making a determination of the reasonableness of compensation.[32]

NOTE: There are court opinions holding that reasonableness can be ascertained by taking into account developments occurring *after* the transaction was consummated. A court opinion issued one week before the proposed regulations were issued found that an event that took place two years after the transaction in question could be taken into account in determining reasonableness.[33]

There is another element as to this matter of reasonableness of compensation worth mentioning. This is a situation where an individual's compensation is suddenly increased from one year to the next. Perhaps there is good reason for this development, but it can attract IRS scrutiny—even if the increased amount is inherently reasonable. This is a type of *relativity test*. These circumstances can be exacerbated where a top executive's compensation is immensely increased, yet there is no comparable increase for any other employer.

Still another point is an individual's prior compensation package. Unless the prior employer is comparable to the new employer (see the first of the above factors), that compensation amount is irrelevant. This can pose a problem for a charitable organization that wants to hire an individual out of another field and that individual expects to retain the same level of compensation as has been paid to him or her; the compensation amount may be reasonable in the prior circumstance, but be excessive when paid by the new charitable employer.

Q 1:13 What items are included in determining the value of compensation?

Compensation for these purposes means all items of compensation provided by an applicable tax-exempt organization (Q 1:6) in exchange for the performance of services. These items include:

1. All forms of cash and noncash compensation, such as salary, fees, bonuses, and severance payments;
2. All forms of deferred compensation that is earned and vested, whether or not funded, and whether or not paid under a de-

ferred compensation plan that is a qualified plan, but if deferred compensation for services performed in multiple years vests in a later year, that compensation is attributed to the year in which the services were performed;

3. The amount of premiums paid for liability or other insurance coverage, as well as any payment or reimbursement by the organization of charges, expenses, fees, or taxes not covered ultimately by the insurance coverage;
4. All other benefits, whether or not included in income for tax purposes, including payments to welfare benefit plans on behalf of the persons being compensated, such as plans providing medical, dental, life insurance, severance pay, and disability benefits, and both taxable and nontaxable fringe benefits (other than certain working condition fringe benefits and de minimis fringe benefits), including expense allowances or reimbursements or foregone interest on loans that the recipient must report as income; and
5. Any economic benefit provided by an applicable tax-exempt organization, whether provided directly or through another entity owned, controlled by, or affiliated with the organization, whether or not the other entity is taxable or tax-exempt.[34]

NOTE: As to the second item, this is a form of lookback rule; the deferred compensation is "attributed" to the prior years of service. (What if there is only one year of prior service?) Perhaps the provision works this way. There is a defined benefit deferred compensation plan, where a benefit is accrued in year 5 based on years of service in years 1–4. The benefit vests immediately in year 5. The benefit is attributed to years 1–4, perhaps ratably, perhaps according to a predefined formula.

Q 1:14 Are any economic benefits disregarded for these purposes?

Yes. They are:

1. Payment of reasonable expenses for members of the governing body of an applicable tax-exempt organization (Q 1:6) to attend meetings of the governing body of the organization.

CAUTION: For this purpose, reasonable expenses do not include luxury travel (undefined) or spousal travel.

2. An economic benefit provided to a disqualified person that the disqualified person receives solely as a member of, or volunteer for, the organization if the benefit is provided to members of the public in exchange for a membership fee of no more than $75 annually.
3. An economic benefit provided to a disqualified person that the disqualified person receives solely as a member of a charitable class that the applicable tax-exempt organization intends to benefit as part of the accomplishment of the organization's exempt purpose.

CAUTION: As to the third exclusion, the proposed regulations state, without explanation, that these benefits are "generally" excluded.[35]

Q 1:15 What is a revenue-sharing transaction?

As noted (Q 1:8), the phrase *excess benefit transaction* can include a *revenue-sharing transaction*. This is any transaction in which the amount of any economic benefit provided to or for the use of a disqualified person is determined in whole or in part by the revenues of one or more activities of the applicable tax-exempt organization (Q 1:6) but only if the transaction results in impermissible private inurement.[36]

A revenue-sharing transaction may constitute an excess benefit transaction, regardless of whether the economic benefit provided to the disqualified person exceeds the fair market value (Q 1:9) of the consideration provided in return, if at any point it permits a disqualified person to receive additional compensation without providing proportional benefits that contribute to the organization's accomplishment of its exempt purposes. If the economic benefit is provided as compensation for services, relevant facts and circumstances include the relationship between the size of the benefit provided and the quality and quantity of the services provided, as well as the ability of the party receiving the compensation to control the activities generating the revenues on which the compensation is based.[37]

NOTE: Under pre-existing law, certain revenue-sharing arrangements have been determined by the IRS to not constitute private inurement. It is to continue to be the case that not all revenue-sharing arrangements are improper private inurement. However, the Department of the Treasury and the IRS are not bound by any particular prior rulings in this area.[38]

Q 1:16 Do these rules apply to sales transactions?

Yes. For example, an excess benefit transaction (Q 1:8) would occur if an asset of an applicable tax-exempt organization (Q 1:6) was sold to a disqualified person (Q 1:23) for less than the fair market value of the asset (Q 1:9).

NOTE: The proposed regulations (Q 1:5) are silent on the matter of a sales transaction constituting an excess benefit transaction.

Q 1:17 Do these rules apply to lending transactions?

Yes. For example, an excess benefit transaction (Q 1:8) would occur if an applicable tax-exempt organization (Q 1:6) lent money to a disqualified person (Q 1:23) at less than a fair market value (Q 1:9) interest rate.

NOTE: The proposed regulations (Q 1:5) are silent on the matter of a lending transaction constituting an excess benefit transaction.

Q 1:18 Do these rules apply to rental transactions?

Yes. For example, an excess benefit transaction (Q 1:8) would occur if an asset of an applicable tax-exempt organization (Q 1:6) was rented to a disqualified person (Q 1:23) for less than the fair rental value (Q 1:9) of the asset.

NOTE: The proposed regulations (Q 1:5) are silent on the matter of a rental transaction constituting an excess benefit transaction.

Q 1:19 What does the phrase *directly or indirectly* mean?

The phrase *directly or indirectly* means the provision of an economic benefit directly by the organization or indirectly by means of a controlled entity.[39] Thus, an applicable tax-exempt organization cannot avoid involvement in an excess benefit transaction by causing a controlled entity to engage in the transaction.

Q 1:20 What does the phrase *for the use of* mean?

A benefit can be provided to a disqualified person even though the transaction is with a person who is not a disqualified person. Benefits of this nature include enhancement of reputation, augmentation of goodwill, or some form of marketing advantage.[40]

Q 1:21 Who has the burden of proof in a dispute with the IRS as to whether a transaction involves an excess benefit?

In an administrative proceeding with the IRS, generally the burden of proof is on the taxpayer. In this setting, the burden of proof is generally on the disqualified person who participated in the transaction. There is, however, a rebuttable presumption of reasonableness with respect to a compensation arrangement with a disqualified person.

NOTE: This rebuttable presumption is not a matter of statute (that is, it is not in the Act); it is provided in the House Report.[41] Also, it is reflected in the proposed regulations.[42]

This presumption arises where the arrangement was approved by a board of directors or trustees (or a committee of the board) that:

1. Was composed entirely of individuals who do not have a conflict of interest (Q 1:22) with respect to the arrangement,

NOTE: This committee may be composed of any individuals permitted under state law to so serve and may act on behalf of the board to the extent permitted by state law.[43] As will be noted, however, committee members who are not board members are likely to be organization managers (Q 1:27).

2. Obtained and relied on appropriate data as to comparability prior to making its determination, and
3. Adequately documented the basis for its determination.[44]

As to the first of these criteria, which essentially requires an *independent* board (as opposed to a *captive* board), a reciprocal approval arrangement does not satisfy the independence requirement. This arrangement occurs where an individual approves compensation of a disqualified person and the disqualified person, in turn, approves the individual's compensation (Q 1:18).

As to the second of these criteria, appropriate data includes compensation levels paid by similarly situated organizations, both tax-exempt and taxable, for functionally comparable positions; the location of the organization, including the availability of similar specialties in the geographic area; independent compensation surveys by nationally recognized independent firms; and written offers from similar institutions competing for the services of the disqualified person.[45]

NOTE: There is to be a safe harbor for organizations with annual gross receipts of less than $1 million when reviewing compensation arrangements. This requires data on compensation paid by five comparable organizations in the same or similar communities for similar services.[46] A rolling average based on the three prior tax years may be used to calculate annual gross receipts.[47]

As to the third of these criteria, adequate documentation includes an evaluation of the individual whose compensation was being established, and the basis for determining that the individual's compensation was reasonable in light of that evaluation and data. The organization's written or electronic records must note the terms of the transaction that was approved, the date of approval, the members of the governing body (or committee) who were present during debate on the transaction or arrangement that was approved and those who voted on it, the comparability data obtained and relied on by the governing body (or committee} and how the data was obtained, and the actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the governing body (or committee) but who had a conflict of interest with respect to the transaction or arrangement.[48]

The fact that a state or local legislative or agency body may have authorized or approved a particular compensation package paid to a

disqualified person is not determinative of the reasonableness of the compensation paid. Likewise, this type of authorization or approval is not determinative of whether a revenue-sharing arrangement violates the private inurement proscription (Q 1:15).

If these three criteria are satisfied, penalty excise taxes can be imposed only if the IRS develops sufficient contrary evidence to rebut the probative value of the evidence put forth by the parties to the transaction. For example, the IRS could establish that the compensation data relied upon by the parties was not for functionally comparable positions or that the disqualified person in fact did not substantially perform the responsibilities of the position.

A similar rebuttable presumption arises with respect to the reasonableness of the valuation of property sold or otherwise transferred (or purchased) by an organization to (or from) a disqualified person if the sale or transfer (or purchase) is approved by an independent board that uses appropriate comparability data and adequately documents its determination.

Q 1:22 What does the phrase *conflict of interest* mean?

The proposed regulations define the phrase *conflict of interest*, as used in the rules concerning the rebuttable presumption of reasonableness (Q 1:21), by defining what is *not* a conflict of interest. Thus, a member of a governing body (or a committee of it) does not have a conflict of interest with respect to a compensation arrangement or transaction if the member:

1. Is not the disqualified person and is not related to any disqualified person participating in or economically benefiting from the compensation arrangement or 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 compensation arrangement or transaction,
3. Is not receiving compensation or other payments subject to approval by any disqualified person participating in or economically benefiting from the compensation arrangement or transaction,
4. Has no material financial interest affected by the compensation arrangement or transaction, and
5. Does not approve a transaction providing economic benefits to any disqualified person participating in the compensation

arrangement or transaction, who in turn has approved or will approve a transaction providing economic benefits to the member.[49]

COMMENT: The statute and the legislative history of the intermediate sanctions rules (Q 1:3, Q 1:4) do not reference the phrase *conflict of interest*. This phraseology was introduced in the intermediate sanctions context by the proposed regulations (Q 1:5) and has been accorded increasing importance as a result.

Q 1:23 What does the term *disqualified person* mean?

The term *disqualified person*, in this context, means

1. Any person who was, at any time during the five-year period ending on the date of the excess benefit transaction involved, in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization involved (whether by virtue of being an organization manager or otherwise),[50]

NOTE: If the five-year period ending on the date of the transaction would have begun on or before September 13, 1995, the period begins on September 14, 1995, and ends on the date of the transaction.[51]

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2. A member of the family of an individual described in the preceding category,[52] and
3. An entity in which individuals described in the preceding two categories own more than 35 percent of an interest.[53]

Q 1:24 What is the scope of the *substantial influence* rule?

An individual is in a position to exercise substantial influence over the affairs of an organization if he or she, individually or with others, serves as the president, chief executive officer, or chief operating officer of the organization.[54] An individual serves in one of these capacities, regardless of title, if he or she has or shares ultimate responsibility for implementing the decisions of the governing body or supervising the management, administration, or operation of the organization.[55]

An individual also is in this position if he or she, independently or with others, serves as treasurer or chief financial officer of the organization.[56] An individual serves in one of these capacities, regardless of title, if he or she has or shares ultimate responsibility for managing the organization's financial assets and has or shares authority to sign drafts or direct the signing of drafts, or authorize electronic transfer of funds, from the organization's bank account(s).[57]

A person can be in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization despite the fact that the person is not an employee of (and does not receive any compensation directly from) the organization but is formally an employee of (and is directly compensated by) a subsidiary—including a taxable subsidiary—controlled by the parent tax-exempt organization.

NOTE: There is a conflict between the legislative history of these rules (Q 1:4) and the proposed regulations (Q 1:5). The legislative history states that an individual having the title of *trustee*, *director*, or *officer* does not automatically have status as a disqualified person. The proposed regulations, however, provide that persons having substantial influence include *any* individual serving on the governing body of the organization who is entitled to vote on matters over which the governing body has authority.[58]

TIP (for professional fund-raisers in the health care setting): Although it is the view of the IRS that all physicians who are on the medical staff of a hospital or similar organization are insiders for purposes of the private inurement proscription,[59] a physician is a disqualified person under the intermediate sanctions rules only where he or she is in a position to exercise substantial influence over the affairs of the organization.[60]

There are some categories of persons who are deemed to not be in a position to exercise the requisite substantial influence. One is any other public charity.[61] Another is an employee of an applicable tax-exempt organization who receives economic benefits of less than the amount of compensation referenced for a highly compensated employee (currently $80,000), is not a member of the family of a disqualified person (Q 1:28), is not an individual referenced above as considered to have this influence, and is not a substantial contributor (*id.*) to the organization.[62]

A person who has managerial control over a *discrete segment* of an organization may be in a position to exercise substantial influence over the affairs of the entire organization.[63]

Facts and circumstances that tend to show substantial influence include the fact that the person founded the organization; is a substantial contributor to the organization; receives compensation based on revenues derived from activities of the organization that the person controls; has authority to control or determine a significant portion of the organization's capital expenditures, operating budget, or compensation for employees; has managerial authority or serves as a key advisor to a person with managerial authority; or owns a controlling interest in a corporation, partnership, or trust that is a disqualified person.[64]

Facts and circumstances that tend to show an absence of substantial influence are where the person has taken a bona fide vow of poverty as an employee, agent, or on behalf of a religious organization; the person is an independent contractor (such as a lawyer, accountant, or investment manager or advisor), acting in that capacity, unless the person is acting in that capacity with respect to a transaction from which the person might economically benefit either directly or indirectly (aside from fees received for the professional services rendered); and any preferential treatment a person receives based on the size of that person's contribution that is also offered to any other contributor making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions.[65]

NOTE: This exclusion for independent contractors does not extend to professional fund-raisers.

Q 1:25 Can a professional fund-raiser be considered to have substantial influence over a charitable organization?

Yes. A fund-raising company, or an individual undertaking fund-raising as an employee or independent contractor, can be a disqualified person with respect to a charitable organization. This can occur when the person is in a position to exercise substantial influence over the affairs of the organization, acting as a manager of it.[66]

The likelihood of this outcome is increased where the fund-raising person is being paid, in whole or in part, on the basis of the revenues of the charitable organization (commission-based or percentage-based fund-raising).[67] The proposed regulations state that facts and circum-

stances tending to show that a person has substantial influence over the affairs of an organization include the fact that the person's compensation is based on revenues derived from activities of the organization that the person controls.[68]

Another element of the proposed regulations that bears on these considerations is the rule that a person "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."[69] Thus, a fund-raising person need not control the charity as such to be a disqualified person. It is only required that the person control a *discrete segment* of the entity. This can happen, for example, in the context of fund-raising by means of sales of services or special event fund-raising.

The proposed regulations contain an illustration of this point. A charity enters into a contract with a company that manages bingo games. Under the contract, the company agrees to provide all of the staff and equipment necessary to carry out a bingo operation one night per week. The charity is to be paid, by the company, a percentage of the revenue from this activity; the company is to retain the balance of the proceeds. The charity does not provide any goods or services in connection with the bingo operation, other than the use of its hall for the bingo games. The annual gross revenue earned from the bingo operation represents more than one-half of the charity's total annual revenue.

By reason of these facts, the bingo management company is a disqualified person with respect to the charity. The company controls the bingo game activity—a discrete segment of the operations of the charity, because it has "full managerial authority" over the charity's principal source of income. The company's compensation is based on revenues from an activity it controls. Consequently, the company is in a position to exercise substantial influence over the affairs of the charity.[70]

A separate example makes the point that those who control a fund-raising company can also be disqualified persons with respect to a charity. In the illustration, the stock of the bingo game management company is wholly owned by an individual, who is actively involved in managing the company. This individual is a disqualified person with respect to the charity.[71]

COMMENT: It is thus critical that a charity review its fund-raising contracts, including general management agreements, to determine

whether the other party to the contract is controlling a discrete segment of the organization and is therefore a disqualified person.

COMMENT 2: Considerable debate has erupted over whether the final regulations should embody some version of a *first-bite rule*, where the initial arm's-length contract entered into by a person with an applicable tax-exempt organization would not be subject to the intermediate sanctions rules.

NOTE: This element of the law leads only to the conclusion that the person is a disqualified one. It does not mean that an excess benefit transaction is involved. Nonetheless, that outcome can be different where the compensation arrangement is a revenue-sharing transaction, as discussed next.

Q 1:26 Can these rules otherwise apply in the fund-raising setting?

Yes, principally in the context of the *revenue-sharing transaction*. In general, an excess benefit transaction is one where an economic benefit is provided by an applicable tax-exempt organization to a disqualified person, where the value of the benefit provided is in excess of the consideration received by the exempt organization (Q 1:8). A simple example of this is an excessive fund-raising fee paid by a charitable organization to a fund-raising company that is a disqualified person.[72]

Another form of excess benefit transaction is the revenue-sharing transaction. This is a transaction where the amount of an economic benefit provided to or for the use of a disqualified person is determined, in whole or part, by the revenues of one or more activities of the organization, where private inurement results (Q 1:15).

The proposed regulations make the point that a revenue-sharing transaction may be an excess benefit transaction regardless of whether the economic benefit provided to the disqualified person exceeds the fair market value of the consideration provided to the exempt organization. This can be the case if, at any point, the transaction permits a disqualified person to receive additional compensation without providing proportional benefits that contribute to the accomplishment of the organization's exempt purposes.[73]

According to the proposed regulations, if this type of economic benefit is provided as compensation for services, the relevant facts and

circumstances to take into account include the relationship between the size of the benefit provided and the quality and quantity of the services provided, as well as the ability of the party receiving the compensation to control the activities generating the revenues on which the compensation is based.[74]

An example in the proposed regulations shows how a revenue-sharing transaction is not necessarily an excess benefit transaction. It concerns the manager of an investment portfolio of an applicable exempt organization. The manager and several other professional investment managers work exclusively for the organization in an office located in the organization's building. The manager's compensation consists of a flat base annual salary, health insurance, eligibility to participate in a retirement plan, and a bonus. This bonus is equal to a percentage of any increase in the value of the organization's portfolio over the year (net of expenses for investment management other than the in-house managers' compensation). The bonus gives the manager an incentive to provide the highest-quality service in order to maximize benefits and minimize expenses to the organization.

In this illustration, the manager has a "measure of control" over the activities generating the revenues on which the bonus is based. At the same time, however, the manager can increase his or her compensation only if the organization also receives a proportional benefit. Under these facts, this revenue-based bonus arrangement, while a revenue-sharing transaction, is not an excess benefit transaction.[75]

The following example in the proposed regulations—much more in the fund-raising setting—illustrates how a revenue-sharing arrangement is an excess benefit transaction. A public charity enters into a contract with a company that manages charitable gaming activities for charities. This company is, because of the contract, a disqualified person (insider) with respect to the charity. The company agrees to provide all of the staff and equipment necessary to carry out the gaming activities for the charity, and to pay the charity a percentage of the net profits (calculated as the gross revenue less rental for the equipment, wages for the staff, prizes for the winners, and other specified operating expenses). The company retains the balance of the proceeds, after payment of the expenses and the charity's share of the profits.

The company controls the activities generating the revenue on which its compensation is based. Because the company owns the equipment and employs the staff, it controls what the charity is charged, including the profit the company makes in that connection. Thus, the company controls the net revenues relative to the gross revenues from the gaming activity.[76]

This example emphasizes the fact that the company is not pro-

vided with an appropriate incentive to maximize benefits and minimize costs to the charity. The company benefits whether the expenses are high and net revenues low or whether expenses are low and the net revenues high. By contrast, the charity suffers if expenses for the gaming operation are high and the net revenues are low. All of the gross revenues generated by the gaming operation belong to the charity. This arrangement allows a portion of these revenues to inure to the company. Under these facts, there is a revenue-sharing transaction, private inurement, and therefore an excess benefit transaction. In fact, the *entire amount* paid to this company is an excess benefit.[77]

COMMENT: It is essential for charities to review their contractual obligations to determine if a revenue-sharing feature lurks in any of them. If there is a revenue-sharing arrangement, the facts and circumstances need to be explored to see if the organization is receiving a proportional benefit as the result of the arrangement and if there is private inurement. If the corresponding benefit is lacking and there is private inurement, an excess benefit transaction is present.

Q 1:27 What does the term *organization manager* mean?

An *organization manager* is a trustee, director, or officer of an applicable tax-exempt organization, as well as an individual having powers or responsibilities similar to those of trustees, directors, or officers of the organization, irrespective of title.[78]

An individual is considered an *officer* of an organization if he or she:

1. Is specifically so designated under the articles of incorporation, bylaws, or other organizing documents of the organization, or
2. Regularly exercises general authority to make administrative or policy decisions on behalf of the organization.

An individual 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.[79]

NOTE 1: Independent contractors, acting in a capacity as lawyers, accountants, and investment managers and advisors, are not officers.[80] There is no comparable exclusion for professional fund-raisers.

NOTE 2: Principles similar to those under the law pertaining to private foundations are to be followed in determining who is an organization manager.

An individual who is not a trustee, director, or officer, and yet serves on a committee of the governing body of an applicable tax-exempt organization that is invoking the rebuttable presumption of reasonableness (Q 1:21) based on the committee's actions, is an organization manager for these purposes.[81]

Q 1:28 What does the term *member of the family* mean?

The term *member of the family* is defined as constituting the following:

1. Spouses, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren—namely, those individuals so classified under the private foundation rules,[82] and
2. The brothers and sisters (whether by the whole or half blood) of the individual and their spouses.[83]

NOTE: Thus, this term is defined more broadly in the public charity setting than is the case with private foundations.

Q 1:29 What is the definition of a *controlled entity*?

The entities that are disqualified persons because one or more disqualified persons own more than a 35 percent interest in them are termed *35-percent controlled entities*.[84] They are:

1. Corporations in which one or more disqualified persons own more than 35 percent of the total combined voting power,
2. Partnerships in which one or more disqualified persons own more than 35 percent of the profits interest, and
3. Trusts or estates in which one or more disqualified persons own more than 35 percent of the beneficial interest.[85]

NOTE: The term *combined voting power* includes voting power represented by holdings of voting stock, actual or

constructive, but does not include voting rights held only as a director or trustee.[86] This rule is identical to that in the private foundation context.[87]

In general, constructive ownership rules apply for purposes of determining what 35-percent controlled entities are.[88]

Q 1:30 Can a tax-exempt organization be a disqualified person?

Yes. A tax-exempt organization, other than a public charity (Q 1:6), can be a disqualified person. All that is required is that an exempt organization is in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization involved (Q 1:23–Q 1:24).

For example, in an instance of an association[89] with a related foundation, the association can be a disqualified person with respect to the foundation. Likewise, a social welfare organization with a related educational foundation can be a disqualified person with respect to that foundation.

NOTE: Other than providing that a public charity cannot be a disqualified person, the proposed regulations (Q 1:5) are silent as to when or whether any other type of tax-exempt organization can be a disqualified person.

Q 1:31 What are the sanctions?

The intermediate sanctions themselves are in the form of tax penalties.[90]

A disqualified person who benefited from an excess benefit transaction is subject to and must pay an initial excise tax equal to 25 percent of the amount of the excess benefit.[91] To reiterate, the excess benefit is the amount by which a transaction differs from fair market value, the amount of compensation exceeding reasonable compensation, or (pursuant to tax regulations) the amount of impermissible private inurement resulting from a transaction based on the organization's gross or net income (Q 1:8, Q 1:15).

NOTE: In addition, the matter must be rectified—*corrected*—by a return of the excess benefit, plus additional compensation, to the applicable tax-exempt organization (Q 1:32).

An organization manager who participated (Q 1:27) in an excess benefit transaction, knowing (Q 1:34) that it was this type of a transaction, is subject to and must pay an initial excise tax of 10 percent of the excess benefit (subject to a maximum amount of tax of $10,000[92]), where an initial tax is imposed on a disqualified person.[93] The initial tax is not imposed where the participation in the transaction was not willful (Q 1:35) and was due to reasonable cause (Q 1:36).[94] There is joint and several liability for these taxes.[95]

An additional excise tax may be imposed on a disqualified person where the initial tax was imposed and if there was no correction of the excess benefit transaction within a specified time period.[96] This time period is the *taxable period*, which means—with respect to an excess benefit transaction—the period beginning with the date on which the transaction occurred and ending on the earlier of:

1. The date of mailing of a notice of deficiency with respect to the initial tax, or
2. The date on which the initial tax is assessed.[97]

In this situation, the disqualified person would be subject to and must pay a tax equal to 200 percent of the excess benefit involved.[98]

Q 1:32 What does the term *correction* mean?

The term *correction* means undoing the excess benefit to the extent possible and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.[99]

Correction of the excess benefit occurs if the disqualified person repays the applicable tax-exempt organization an amount of money equal to the excess benefit, plus any additional amount needed to compensate the organization for the loss of the use of the money or other property during the period commencing on the date of the excess benefit transaction and ending on the date the excess benefit is corrected.[100] According to the proposed regulations (Q 1:5), correction may also be accomplished, in certain circumstances, by returning property to the organization and taking any additional steps necessary to make the organization whole.[101]

NOTE: The proposed regulations do not state what these "certain circumstances" might be nor do they reveal what the "additional steps" might entail.

Q 1:33 What does the term *participation* mean?

The term *participation* includes silence or inaction on the part of an organization manager where he or she is under a duty to speak or act, as well as any affirmative action by the manager.[102] An organization manager, however, is not considered to have participated in an excess benefit transaction where the manager has opposed the transaction in a manner consistent with the fulfillment of the manager's responsibilities to the applicable tax-exempt organization.[103]

Q 1:34 What does the term *knowing* mean?

A person participates (Q 1:33) in a transaction, *knowing* that it is an excess benefit transaction, only if the person:

1. Has actual knowledge of sufficient facts so that, based solely on those facts, the transaction would be an excess benefit transaction,
2. Is aware that the act under these circumstances may violate the excess benefit transaction rules, and
3. Negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the person is in fact aware that it is an excess benefit transaction.[104]

Knowing does not mean reason to know. Evidence tending to show, however, that a person has reason to know of a particular fact or particular rule is relevant in determining whether the person had actual knowledge of the fact or rule. For example, evidence tending to show that a person has reason to know of sufficient facts so that, based solely on those facts, a transaction would be an excess benefit transaction, is relevant in determining whether the person has actual knowledge of the facts.[105]

Q 1:35 What does the term *willful* mean?

Participation in a transaction by an organization manager is *willful* if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. Participation by an organization manager, however, is not willful if the manager does not know (Q 1:34) that the transaction in which the manager is participating is an excess benefit transaction.[106]

Q 1:36 What does the term *reasonable cause* mean?

An organization manager's participation is due to *reasonable cause* if the manager has exercised his or her responsibility on behalf of the organization with ordinary business care and prudence.[107]

TIP: If a person, after full disclosure of the factual situation to a lawyer (including in-house counsel), relies on the advice of the lawyer—expressed in a reasoned legal opinion—that a transaction is not an excess benefit transaction, the person's participation in the transaction will ordinarily not be considered knowing or willful and will ordinarily be considered due to reasonable cause, even if the transaction is subsequently held to be an excess benefit transaction. The absence of advice of legal counsel with respect to an act does not, by itself, give rise to an inference that a person participated in the act knowingly, willfully, or without reasonable cause.[108]

CAUTION: A written legal opinion is *reasoned* so long as it addresses the facts and applicable law. An opinion is not reasoned if it does nothing more than recite the facts and state a conclusion.[109]

Q 1:37 Are there any deficiencies in these proposed regulations?

Yes. The proposed intermediate sanctions regulations contain some deficiencies that, ideally, will be remedied in the final version of the package. Here are some of them.

REASONABLENESS

The core underpinning of the intermediate sanctions rules is the standard of reasonableness. That is, for the most part, a transaction is not an excess benefit one if the terms of it are reasonable (Q 1:8). The focus in this regard primarily is on compensation arrangements; if the compensation arrangement is reasonable, it is not likely to be an excess benefit transaction. (These qualifiers are there in recognition of the rules pertaining to revenue-sharing arrangements (Q 1:15).)

With this much emphasis on reasonableness and compensation arrangements, the proposed regulations should provide substantive guidance as to the factors to be taken into account in determining reasonableness of compensation (Q 1:12). All that is provided in the gen-

eral rules is this: "Compensation 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."[110] This is a marvelous summary of the standard; it is, however, too skimpy for these purposes.

One of the anomalies of the proposed regulations is that, in the rules pertaining to the rebuttable presumption of reasonableness, where appropriate data as to comparability is required, some specific elements are laid out to use in determining what is reasonable (Q 1:21). The list of elements (including comparable compensation levels and offers from similar entities) is useful as far as it goes but there are other elements (as reflected in case law). These include the training, education, and expertise of the disqualified person; the scope of the person's duties; and the amount of time the person is devoting to the job.

So, there are two points. One, the criteria set forth in the context of the rebuttable presumption should be expanded. Two, the regulations should make it clear that the same criteria may be used in determining reasonableness under the general rules.

These observations also pertain to other types of excess benefit transactions, such as lending and rental arrangements. The proposed regulations recite the general rule defining what the fair market value of property is (a willing buyer and willing seller, etc. (Q 1:9)) but that is all. The proposed regulations should be amplified in this setting also. Thus, for example, in the lending context, the regulations could focus on elements such as the amount of the loan, its term, repayment conditions, and security. In the rental setting, the elements include the amount of the rent, the term of the lease, and other terms and conditions of the lease.

EXEMPT ORGANIZATIONS AS DISQUALIFIED PERSONS

A tax-exempt organization, whether or not an applicable one, has the potential to be a disqualified person. Yet, with one exception, the regulations are silent on this point. The exception is the proposed rule that public charities are not to be regarded as disqualified persons (Q 1:30).

It is quite common for a tax-exempt organization to be in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization. Indeed, the exempt organization often *controls* the applicable tax-exempt organization (a parent-subsidiary relationship). The two most prevalent examples are the tax-exempt association that

has a related "foundation" and the exempt social welfare organization that has a related educational organization.

The proposed regulations, however, are silent on this matter. Some guidance on the subject of exempt organizations as disqualified persons would be helpful.

REBUTTING THE PRESUMPTION

The IRS can rebut the presumption of reasonableness. The proposed regulations state that this can be accomplished by means of "additional information."[111] They do not, however, identify what that might be.

The proposed regulations should provide some insight as to what the additional information might be and discuss the process that is to be followed when the IRS endeavors to rebut the presumption.

CORRECTION

The proposed regulations describe the general process to utilize when correcting (undoing) an excess benefit transaction (Q 1:32). Basically, correction is accomplished by paying back a sum of money equal to the excess benefit, plus an additional sum to compensate the exempt organization for the use of the money or property involved.

The proposal also states that correction "may also be accomplished, in certain circumstances, by returning property to the organization and taking any additional steps necessary to make the organization whole."[112]

The proposed regulations are silent on what "certain circumstances" and "additional steps" mean. It would be helpful if these phrases were explained.

Subsequent to issuance of the proposed regulations, IRS personnel began articulating the view that simple correction, as noted above (such as writing a check to the charity involved), is not sufficient. Rather, the view now is that the charity must take meaningful steps to change the facts to ensure that the type of transgression that gave rise to the penalties will not reoccur. If this is to be the law, this concept should be added to the regulations in final form.

PRIVATE INUREMENT DOCTRINE

The legislative history of the intermediate sanctions rules (Q 1:4) states Congress' expectation that the rules generally will be applied

rather than the private inurement doctrine (which can lead to revocation of status). This history also makes it clear, nonetheless, that the private inurement doctrine is to be applied where the factual situation is egregious.[113]

The proposed regulations do not address this point and it would be appropriate for them to do so.

CLARIFICATIONS

Some statements in the proposed regulations are not entirely clear and these should be clarified.

One relates to the point that the rebuttable presumption can be invoked where there is reliance on the determination of a board committee (Q 1:21). The sentence reads: "An arrangement or transaction has not been approved by a committee of a governing body if, under the governing documents of the organization or state law, the committee's decision must be ratified by the full governing body in order to become effective."[114]

What does that mean? Does it mean that a committee's determination cannot be used in those situations where the decision must be ratified? Or does it mean that the effectiveness of the committee's decision is postponed until ratified and then it becomes valid? Under the first interpretation, the presumption would not be available to organizations in those circumstances (that is, using committees rather than full boards); hopefully, that is not the rule. Under the second interpretation, the committee's decision is valid for purposes of the presumption but only after the governing body ratifies it, even if the governing body itself is not entirely an independent one; hopefully, that is the rule.

Another example is that the word *includes* is improperly used in some places in these regulations. For example, "[c]ompensation for purposes of section 4958 includes all items of compensation provided by an applicable tax-exempt organization in exchange for the performance of services."[115] Here, *includes* suggests that compensation might include something other than compensation, and surely that is not intended.

The same defect appears in the definition of the term *family members* as part of the process of ascertaining all disqualified persons with respect to an organization (Q 1:28). The proposed regulations state that an individual's *family* includes certain categories of individuals[116]—but the list of them is complete.

Q 1:38 Do these proposed regulations overreach in relation to the statute and its legislative history?

A case certainly can be made that, in one or more respects, the proposed regulations extend too far beyond the confines of the underlying law. There are some ramifications here for professional fund-raisers.

The general test to be applied in answering this question is whether a regulation is unreasonable or plainly inconsistent with the statute. If a regulation is overly broad, it may be voided by a court.

Here are some of the aspects of the regulations that need to be tested against the standard that regulations may not be overly broad.

DISQUALIFIED PERSONS

The statute basically defines the term *disqualified person* as any person who was, during the five-year lookback period, "in a position to exercise substantial influence over the affairs of the organization" (Q 1:23). This definition is repeated in the proposed regulations.

The proposal, however, introduces a facts and circumstances test. By reason of this rule, a person may be a disqualified person if the person has managerial control over a discrete segment of an organization (Q 1:24). That clearly goes beyond the bounds of the statute's definition. The statute speaks of "*the* affairs of the organization." It does not use the words *"some of the* affairs of the organization." Is the proposed definition too broad? Or is it a reasonable interpretation of congressional intent? Probably the latter but it is a close call.

One of the factors under the proposed facts and circumstances test that tends to show substantial influence is whether the person has authority to control or determine a *significant portion* of the organization's capital expenditures, operating budget, or compensation for employees.[117] Again, the statutory definition of disqualified person does not use the words "a significant portion of the affairs of the organization." Is this proposal overly broad? It is another close call.

The proposed regulation, having introduced the concept of "managerial control," goes beyond itself. One of the factors stated that tends to show substantial influence is whether a person "serves as a key advisor to a person with managerial authority."[118] It goes without saying that a fund-raising professional could be in this position. Thus, a person who does not have substantial influence over the *affairs* of an organization and who does not have *managerial control* over a *discrete*

segment of the organization may nonetheless be a disqualified person by reason of being a *key advisor* to a disqualified person. Is this an overly broad rule?

The legislative history of these rules states that an individual having the title of trustee, director, or officer does not automatically have status as a disqualified person (Q 1:24). Thus, for example, one director of a 100-person board may not be a disqualified person if he or she is not an officer or committee chair (or perhaps not even a committee member), because of lack of the necessary influence. The proposed regulations, however, provide that individuals having substantial influence include anyone serving on the governing body of the organization who is entitled to vote. Is this proposal overly broad? It certainly is inconsistent (*id.*).

REBUTTABLE PRESUMPTION

The legislative history of the intermediate sanctions rules created a rebuttable presumption of reasonableness (Q 1:21). One of the elements needed to trigger the presumption is approval of the transaction by an independent board of directors or board committee. The concept of *independence* is there defined in terms of individuals who are related to and controlled by the disqualified person involved.

The proposed regulations address the matter of *independence* by utilizing the concept of *conflict of interest* (1:22). Is this overlay of a conflict-of-interest standard overly broad in relation to what Congress wrote? It certainly is different.

According to the legislative history, another element needed to invoke the presumption is that the organization must *adequately* document the basis for its determination. A review of the requirements laid out in the proposed regulations for showing *adequate* documentation raises the question as to whether the criteria go beyond any reasonable concept of adequacy.

Also, with respect to this element, the regulations add the requirement that the documentation be made *concurrently* with the determination. Is adequacy measured by the content and substance of the documentation? Does adequacy reasonably embrace the timing of the documentation?

COMPENSATION

The statute provides that an economic benefit cannot be treated as consideration for the performance of services unless the organization

clearly indicated its intent to treat the benefit as an item of compensation (Q 1:10). This standard is reflected in the general, introductory portion of the proposed regulation.

When, however, the standard is addressed in more specific regulations, the requirement becomes one where the organization must demonstrate *clear and convincing* evidence of the requisite intent. Is this standard overly broad? It certainly is broader.

ORGANIZATION MANAGERS

The statute defines the term *organization manager* to mean any officer, director, or trustee of an organization. It also states that an organization manager means an individual having powers or responsibilities similar to those of officers, directors, or trustees of the organization. (Q 1:27)

The proposed regulations track this definition. Nonetheless, the proposal embodies a "special rule." This rule states that an individual who is not an officer, director, or trustee of an organization, yet serves on a committee of the organization that is invoking the rebuttable presumption of reasonableness, is an organization manager (Q 1:27). Is this special rule too broad? Can it be said that an individual of this nature always has powers or responsibilities similar to those of officers, directors, or trustees of the organization? This one, while broader than the underlying law, is in all likelihood in effectuation of congressional intent.

Q 1:39 Can there be joint liability for these taxes?

Yes. If more than one organization manager or other disqualified person is liable for an excise tax, then all of these persons are jointly and severally liable for the tax.[119]

Q 1:40 Is there any relief from this tax scheme? Any basis for being excused from the penalties?

Yes, there is a limited form of relief. Congress has provided the IRS with the authority to abate the intermediate sanctions excise tax in certain circumstances, principally where a taxable event was due to reasonable cause and not to willful neglect, and the transaction at issue was corrected within the specified taxable period (Q 1:36, Q 1:35, Q 1:32).[120]

Q 1:41 How are these taxes calculated and reported?

Under the law in existence prior to the enactment of intermediate sanctions, charitable organizations and other persons liable for certain excise taxes must file returns by which the taxes due are calculated and reported. These taxes are those imposed on public charities for excessive lobbying and for political campaign activities, and on private foundations and/or other persons for a wide range of impermissible activities. These returns are on Form 4720.

This form is now also used in the excess benefit transaction penalties context. In general, returns on Form 4720 for a disqualified person or organization manager liable for an excess benefit transaction tax must be filed on or before the 15th day of the fifth month following the close of that person's tax year.

Q 1:42 Can an organization reimburse a disqualified person for these taxes?

Yes. However, any reimbursements by an applicable tax-exempt organization of excise tax liability are treated as an excess benefit unless they are included in the disqualified person's compensation during the year in which the reimbursement is made. (This rule is consistent with that noted above (Q 1:10), which is that payments of personal expenses and other benefits to or for the benefit of disqualified persons are treated as compensation only if it is clear that the organization intended and made the payments as compensation for services.) The total compensation package, including the amount of any reimbursement, is subject to the requirement of reasonableness.[121]

Q 1:43 Can an organization purchase insurance for a disqualified person to provide coverage for these taxes?

Yes. But, again (Q 1:10), the payment by an applicable tax-exempt organization of premiums for an insurance policy providing liability insurance to a disqualified person for excess benefit taxes is an excess benefit transaction unless the premiums are treated as part of the compensation paid to the disqualified person and the total compensation (including premiums) is reasonable.[122]

Q 1:44 Does the payment of an intermediate sanctions tax have any direct impact on a tax-exempt organization?

There are two ways in which the payment of an intermediate sanctions tax can have an impact on a tax-exempt organization. One would occur

when the payment of the tax triggers a reimbursement by the organization or coverage under an insurance policy that it has purchased (Q 1:42–1:43).

The other way an impact can occur arises from the fact that applicable tax-exempt organizations are required to disclose on their annual information returns the amount of the excise tax penalties paid with respect to excess benefit transactions, the nature of the activity, and the parties involved (Q 1:41).

There is a third factor that does not directly relate to the payment of an intermediate sanctions penalty, but rather concerns the intermediate sanctions rules as such. As the rules pertaining to the rebuttable presumption of reasonableness (Q 1:21), for example, illustrate, a consequence of these rules can be a dramatic change in the way an organization operates. That is, the intermediate sanctions rules place considerable emphasis on *process*. The advent of them will, in many instances, change an organization's process—its way of functioning. In deciding whether there has been a violation in this context, the IRS will be viewing an organization's process as a key element.

Q 1:45 Is there a limitations period, after which these taxes cannot be imposed?

Yes, in general.[123] The period set by the statute of limitations for the assessment of the intermediate sanctions excise taxes against a disqualified person generally is three years from the date the applicable tax-exempt organization's annual information return is filed, provided the transaction giving rise to the tax is adequately disclosed on the return or in a statement attached to the return.[124] The statute of limitations period, however, will be six years from the date the organization's return is filed if the transaction was not adequately disclosed on the return. In the case of a false or fraudulent return, or a return made with the willful attempt to evade tax, an excise tax may be assessed at any time. In the event that a return has not been filed, the tax may be assessed at any time.[125]

Q 1:46 Do intermediate sanctions take precedence over other sanctions the IRS has?

Basically, yes. Intermediate sanctions may be imposed by the IRS in lieu of or in addition to revocation of an organization's tax-exempt

status. In general, these intermediate sanctions are to be the sole sanction imposed in those cases in which the excess benefit does not rise to a level where it calls into question whether, on the whole, the organization functions as a charitable or social welfare organization. It is significant, however, that in the case involving the first application of the intermediate sanctions penalties to be litigated (Q 1:49), the IRS also revoked the tax-exempt status of the three charitable organizations involved.

In practice, the revocation of tax-exempt status, with or without the imposition of these excise taxes, is to occur only when the organization no longer operates as a charitable or social welfare organization, as the case may be. Existing law principles apply in determining whether an organization no longer operates as an exempt organization. For example, in the case of a charitable organization, that would occur in a year, or as of a year, the entity was involved in a transaction constituting a substantial amount of private inurement.

Q 1:47 Won't the private inurement doctrine have an impact on definitions of excess benefit transactions?

Absolutely. The concepts of private inurement and excess benefit transaction are much the same. Thus, a great amount of existing law as to what constitutes private inurement will be applied in determining what amounts to excess benefit transactions. While this will be the case particularly with respect to compensation issues, it will also be true in the realms of lending, borrowing, sales arrangements, and the like. Indeed, some of this law is specifically said by the legislative history to be predicated on the private inurement doctrine, such as the rules pertaining to revenue-sharing arrangements (Q 1:15).

Q 1:48 When will the intermediate sanctions regulations be issued in final form?

At this point, probably no one knows. The project was part of the IRS and Department of Treasury business plan for 1999. Obviously, that element of the plan was not forthcoming.

Given the complexity of the issues to be resolved and reflected in the final regulations, however, the regulations are, as of mid-2000, months away from being issued in final form. They may be issued

before 2000 ends. There is an equal chance that they will emerge in 2001.

Q 1:49 Has any litigation concerning the intermediate sanctions rules been initiated?

Yes. The first of these cases was filed in the U.S. Tax Court on November 15, 1999.[126] There are eight petitions altogether. The intermediate sanctions taxes imposed total about $240 million.