IRS Intermediate Sanctions: How They Will Impact Colleges and Universities

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On July 30, 1998, the Department of Treasury issued for public comment its eagerly awaited proposed regulations implementing the intermediate sanctions provisions for public charities under § 4958 of the Internal Revenue Code.[1] The provisions impose penalty excise taxes on transactions with parties who take improper advantage of public charities for their own private benefit. The implementing regulations present the most sweeping governance and administrative rules that nonprofit organizations have faced since the 1959 regulations under § 501(c)(3) defined the parameters for charitable activities.

Colleges and universities will be interested in the intermediate sanctions regulations because they are much more specific than the statute in showing how the taxes could affect many common institutional transactions. Compensation not only for the chief administrative officers of a school but also for influential academic officers, athletic coaches, and board members can potentially be subject to these new taxes. Purchases and sales of property from suppliers with a close relationship to the institution, including suppliers who are substantial donors, can also potentially be subject to these taxes. To balance the risks that are identified more explicitly, the proposed regulations explain how institutions that are conscientious in handling the process for approving transactions with influential individuals and companies can establish important protections from the taxes.

This article provides an overview of the penalty excise tax scheme and a detailed explanation of the proposed regulations. Particular attention is paid to aspects of the rules that make direct reference to colleges and universities or are likely to affect typical college and university operations.

Background

Until intermediate sanctions were enacted in July of 1996, the Internal Revenue Service (IRS) had a single enforcement tool it could use when it discovered that a person had abused a public charity by using his influence to extract unwarranted benefits for himself or his family. The sanction was rev-

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1. Prop. Treas. Reg. § 53.4958-1 to § 53.4958-7, 63 Fed. Reg. 41.4 (1998). All statutory references are to the Internal Revenue Code of 1986. All regulatory references are to the Treasury Regulations promulgated under the Code.

ocation of tax-exempt status, and it could have a devastating effect on a charity, especially if it relied on either deductible charitable contributions or tax-exempt financing for support. Revocation is often a disproportionate and misdirected sanction, inappropriately punishing an organization, its employees, and most importantly, those it serves, while allowing the insiders who benefited from the abusive transaction to retain the benefit of their misconduct.

The concept of intermediate sanctions for charities — sanctions short of revocation of tax exemption — was introduced into the Internal Revenue Code with the 1969 enactment of the private foundation rules. These rules establish a two-tier penalty tax system for self-dealing transactions, expenditures for non-charitable purposes, and certain other broad categories of acts. The suggestion that intermediate sanctions be extended to public charities was made as early as 1977, in the report of the Commission on Private Philanthropy and Public Needs (often known as the Filer Commission).[2]

In 1976, and again in 1987, Congress created a form of intermediate sanctions for public charities that engage in lobbying or political activities in violation of the requirements of § 501(c)(3).[3] However, it did not turn to the need for intermediate sanctions for violations of the prohibition on private inurement until the early 1990s when it became concerned about improprieties involving a few tax-exempt charities and the IRS's inability to deal with these potentially abusive transactions short of revocation of tax exemption.

The Clinton Administration shared Congress's concern that existing tax law did not adequately to curtail abusive transactions. The Administration's views were first expressed by IRS Commissioner Margaret Richardson testifying at a hearing of the House Ways and Means Oversight Committee investigating specific cases of perceived abuse.[4] Richardson stressed that the absence of any sanctions short of revocation for public charity violations of the private inurement and private benefit rules was creating serious enforcement problems for the Service. The Commissioner noted that the consequences of revocation are often highly disproportionate to the violation, and often punish the wrong parties by threatening the continued existence of the public charity and its ability to perform needed services for its community while allowing those abusing the charity to retain the benefits of their misconduct.

2. DEPARTMENT OF TREASURY, COMM'N ON PRIVATE PHILANTHROPY AND PUB. NEEDS, GIVING IN AMERICA 173-8 (1975). The Department of the Treasury subsequently wrote to the Chairman of the House Ways and Means Committee and the Chief of Staff of the Joint Committee on Taxation advocating the adoption of measures substantially similar to those recommended by the Commission.

3. In 1976, Congress incorporated a form of intermediate sanctions in the § 501(h) rules governing lobbying by public charities, and, in 1987, adopted a two-level, foundation-type penalty tax scheme in § 4955 for public charity violations of the prohibition on intervention in political campaigns.

4. *Federal Tax Laws Applicable to the Activities of Tax-Exempt Charitable Organizations: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 103rd Cong. (1993) (statement of Margaret Richardson, Commissioner, IRS).

Although the IRS has made increasing use of closing agreements, requiring public charities to take various corrective acts as a condition for the Service refraining from proposing revocation of exemption, the Commissioner stressed the limitations of this strategy. In particular, she noted that because closing agreements are negotiated on a case-by-case basis, it is difficult to ensure consistent results, and further, because closing agreements are negotiated after the violation and are not publicized, they provide limited guidance, or deterrence, for other organizations. Furthermore, they can reach only the organization and not the individuals who have drained its resources.

Not long after the Commissioner's testimony, the Administration proposed that intermediate sanctions, short of revocation, be enacted for public charities in violation of the inurement prohibition. The Department of Treasury consulted with the IRS and then forwarded to Congress a detailed proposal for legislation intended to provide the government with effective targeted sanctions. The general approach was to adopt a series of graduated levels of penalty taxes on "disqualified persons" and "organization managers" that engage in "excess benefit transactions" for their own private benefit with "applicable tax-exempt organizations."[5]

Congress agreed that it needed to cure this serious weakness in the tax law, and with broad support from the charitable sector enacted a "narrowly tailored" intermediate sanctions scheme, based on the Treasury proposal, taxing excess benefit transactions and unreasonable compensation agreements between public charities and disqualified persons. The legislation also extended the inurement proscription to § 501(c)(4) organizations and made them subject to intermediate sanctions as well. Intermediate sanctions were enacted as new § 4958 of the Code on July 30, 1996.

General Overview of the Statutory Scheme

Under § 4958, a tax applies to each "excess benefit transaction" involving a § 501(c)(3) or § 501(c)(4) organization. An "excess benefit transaction" is a transaction in which an applicable tax-exempt organization provides an economic benefit directly or indirectly to or for the use of a disqualified person and the value of the economic benefit exceeds the value of the consideration provided in return. A "disqualified person" is generally a person (including not only a natural person but also a trust, estate, association, or corporation) in a position to exercise substantial influence over the affairs of the organization.[6] A "disqualified" person can also be a member of the family of an individual with substantial influence or an entity in which more than thirty-five percent of the ownership or beneficial interests are held by persons with substantial influence. The disqualified person who receives the benefit must pay the tax on the excess benefit transaction.

The tax on excess benefit transactions has two tiers. The first tier tax is equal to twenty-five percent of the excess benefit the disqualified person re-

5. *Treasury Sends Congress Details of Penalty Proposal for Abusive Exempts*, 1995 Daily Tax Rep. (BNA) 153 (Aug. 8, 1995).

6. I.R.C. § 4958(f)(1)(A) (1998).

ceives (i.e. twenty-five percent of the excess of the value of the benefit received over the value of the consideration provided in return). The second tier tax is equal to 200% of the excess benefit the disqualified person receives. The disqualified person must pay the second-tier tax if the excess benefit transaction is not *corrected* before the IRS issues a notice of deficiency for or assesses the first-tier tax.

A separate tax is imposed under § 4958 on the participation of any "organization manager" in an excess benefit transaction, knowing it to be such a transaction, unless the participation is not willful, or is due to reasonable cause. The tax must be paid by the organization manager and is equal to ten percent of the excess benefit. The maximum tax that can be imposed on the participation of organization managers is $10,000 per transaction. If more than one organization manager is liable for the tax with respect to a single transaction, then each such manager is jointly and severally liable for the tax owed. An individual who is both a disqualified person and an organization manager can be liable for both the tax on the transaction itself and the organization manager tax.

The tax on excess benefit transactions and the tax on participation in excess benefit transactions by organization managers apply generally to transactions occurring on or after September 14, 1995. There is an exception for transactions that occur pursuant to a contract that was binding before September 14, 1995.

As part of the scheme, Congress provided for abatement of the first-tier tax if it can be established that the excess benefit transaction was due to reasonable cause, not due to willful neglect, and the transaction was corrected within ninety days after the IRS mailed a notice of deficiency. Although not made a part of the legislation, the House Report expressed the intent that parties to a transaction are entitled to rely on a "rebuttable presumption" that compensation is reasonable and property is given fair market value if the compensation or property transaction is approved by disinterested individuals on behalf of the organization. Data on comparable transactions is taken into consideration, and the basis of the determination is recorded in writing in and around the time the determination is made.[7] If these three conditions are met, the burden falls on the IRS to introduce new evidence showing that compensation was not reasonable or a transaction was not at fair market value.

With the issuance of the proposed regulations, significantly more detailed guidance is available to help understand the terms created by the statute and the ways in which the taxes may be applied. The definition of key terms and the operation of the statute as explained in both the Code and the proposed regulations is described in detail in the following sections.

7. H.R. REP. No. 104-506, at 56-7 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1179-80.

Applicable Tax-exempt Organization

Generally, an "applicable tax-exempt organization" includes a § 501(c)(3) or § 501(c)(4) organization exempt from Federal income tax under § 501(a). The organization's ability to qualify for exemption is determined without regard to any excess benefit transaction.[8] There is also a five-year look-back rule. If an organization has been described in § 501(c)(3) or § 501(c)(4) and is exempt from tax under § 501(a) at any time during the five year period ending on the date of the transaction, then it is considered an applicable tax-exempt organization for purposes of § 4958.

The proposed regulations make clear that for purposes of § 4958, an organization will be treated as described in § 501(c)(3) and exempt under § 501(a) only if the IRS is permitted to treat the organization as such under the rules of § 508.[9] Section 508 allows the IRS to treat an organization as described in § 501(c)(3) only if:

- the IRS has given the organization a written determination that it is described in § 501(c)(3);[10]
- the organization is a church, an integrated auxiliary of a church, or a convention or association of churches;[11] or
- the organization is not a private foundation, and its gross receipts in each taxable year are normally not more than $5,000.[12]

The proposed regulations make clear that for purposes of § 4958, an organization will be treated as described in § 501(c)(4) and exempt under § 501(a) only if:

8. Because the excess benefit transaction would constitute inurement in violation of the requirements of § 501(c)(3) and § 501(c)(4), if taken into account, it would have an effect on whether the organization was described in § 501(c)(3) or § 501(c)(4). Until September 14, 2000, the look-back period will be less than five years. Instead, it will be the period beginning September 14, 1995 and ending on the date of the transaction.

9. Prop. Treas. Reg. § 53.4958-2(b), 63 Fed. Reg. 41486 (1998).

10. I.R.C. § 508(a)(1) (1998).

11. I.R.C. § 508(c)(1)(A) (1998). There are no formal statutory or regulatory definitions of what constitutes a church for these purposes. There, is however, regulatory guidance on what constitutes an "integrated auxiliary of a church." Under § 6033(a)(2)(A), churches, their integrated auxiliaries, and conventions or associations of churches are exempted from the requirement of filing an annual information return that applies to most other § 501(c)(3) organizations. Treasury Regulation § 1.6033-2(h) defines an integrated auxiliary of a church as an organization that is described in § 501(c)(3), is not a private foundation, is "affiliated with a church or convention or association of churches and [is] internally supported." Further guidance is then provided on the affiliation and internal support requirements. Three examples illustrate the operation of this standard.

Even if religiously affiliated, most colleges and universities, other than seminaries, will not be integrated auxiliaries of churches. They will not meet the internal support requirement if they offer admission to the general public and normally receive more than half of their support from fees paid for their services, government sources, and publicly solicited contributions. *See* Treas. Reg. § 1.6033-2(h)(4) (1998).

12. I.R.C. § 508(c)(1)(B) (1998).

- the IRS has given the organization a written determination that it is described in § 501(c)(4);
- the organization has filed an application with the IRS for recognition of exemption under § 501(c)(4);
- the organization has filed an information return as a § 501(c)(4) organization under the IRC or accompanying regulations; or
- the organization has held itself out as being described in § 501(c)(4).[13]

State and Local Government Entities

Certain entities that are formed and operated under the auspices of state or local government, such as hospitals and universities, meet the requirements to be described in § 501(c)(3) — or perhaps § 501(c)(4) — but they do not always apply to the IRS for a determination letter. These institutions do not need a § 501(c)(3) or § 501(c)(4) determination letter to be relieved of their federal income tax burden if they are considered a part of the state or local government, which is not taxed under federal law, or if running the institution is considered an essential governmental function that does not generate income subject to tax under § 115 of the Internal Revenue Code.[14] However, some such institutions elect to apply for and receive a § 501(c)(3) determination letter. If a state or local governmental entity has a determination letter concluding that the entity is described in § 501(c)(3) or § 501(c)(4) and exempt from tax under § 501(a), then under the proposed regulations the entity is an applicable tax-exempt organization for purposes of § 4958. Conversely, if a state or local governmental entity does not have an IRS determination letter concluding that the entity is described in § 501(c)(3) or § 501(c)(4) and exempt from tax under § 501(a), and the entity has not applied for such a letter, filed an information return as a § 501(c)(4) organization, or otherwise held itself out as a § 501(c)(4) organization, then the entity would not be an applicable tax-exempt organization for purposes of § 4958.

13. Prop. Treas. Reg. § 53.4958-2(c), 63 Fed. Reg. 41,486 (1998). One commentator has questioned whether the regulation makes clear that intermediate sanctions do not apply to organizations, which could be described in § 501(c)(4), but ultimately do not qualify or claim to be exempt. The structure of the regulation prevents an organization from being subject to intermediate sanctions without its knowledge and the agreement of the IRS that the organization is in fact described under § 501(c)(4) and exempt under § 501(a). If the organization does not qualify for exemption, it is not an applicable tax-exempt organization within the definition of § 4958(e), and the IRS has no authority to impose intermediate sanctions on the organization's transactions. If the organization could qualify but has elected not to be exempt, then it will not be taking any of the actions, e.g. filing an exemption application or representing itself to the public as a § 501(c)(4) organization, that would cause it to be treated as an applicable tax-exempt organization under the regulations.

14. Section 115 provides that gross income does not include income "derived from . . . the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia . . . ."

Application to Colleges and Universities

Private nonprofit colleges and universities will generally be considered applicable tax-exempt organizations because they usually possess determination letters from the IRS. Colleges and universities that are organized and operated by state or local government are generally not applicable tax-exempt organizations unless they have obtained § 501(c)(3) determination letters from the IRS. In the latter case, the proposed regulations would make a state or local institution with a determination letters an applicable tax-exempt organization.[15] Foreign colleges and universities will not be considered applicable tax-exempt organizations if they receive substantially all of their support from sources outside the United States.[16] Even if religiously affiliated, most colleges and universities, other than seminaries, will not be integrated auxiliaries of churches because they offer admission to the general public and normally receive more than half of their support from fees paid for their services, government support and publicly solicited contributions. As a result, they are not considered "internally supported" and do not meet the definition in the regulations of an integrated auxiliary.

Disqualified Persons

The statute defines a "disqualified person" as an individual who, at any time during the five years prior to the transaction in question, was "in a position to exercise substantial influence over the affairs of the organization."[17] The statute also provides that any member of a disqualified person's family, as well as any entity in which a disqualified person or family member owns more than thirty-five percent of the control or beneficial interests, is also a disqualified person.[18] For purposes of these rules, a person's family includes the following individuals:

- spouse;
- brother or sister (including half-brothers and sisters);
- spouse of brother or sister;

15. Several comments on the proposed regulations have suggested changing this rule. J.S. Almond of Purdue University has suggested that the rule be amended to apply to organizations that derive their tax exemption solely from § 501(c)(3). He argues that the current rule creates an unfair disparity between otherwise similar state and local institutions. Sheldon Steinbach, writing on behalf of the American Council on Education, has suggested providing an exception for any state or local college or university that applied for a determination letter and received it before § 4958 was enacted. He argues that once a determination is given, it cannot be "given back," and it is unfair to subject these institutions to sanctions that they could not have considered at the time they applied for exemption.

16. Prop. Treas. Reg. § 53.4958-2(c), 63 Fed. Reg. 41,486 (1998). This position with respect to foreign organizations is mandated by § 4948(b), which provides that chapter 42 "shall not apply to any foreign organization, which has received substantially all of its support (other than gross investment income) from sources outside the United States." I.R.C. § 4958 (1998).

17. I.R.C. § 4958(f)(1)(A) (1998).

18. I.R.C. §§ 4958(f)(1)(B) & (C) (1998).

ancestor;

child;

grandchild;

great grandchild;

- spouse of child, grandchild or great grandchild.[19]

Note that aunts, uncles and cousins are not included in this list.

The proposed regulations provide that certain categories of individuals and entities are automatically disqualified persons, certain categories are automatically not disqualified persons, and all others fall under a facts and circumstances test. The proposed regulations provide a number of helpful examples to show how the disqualified person rules work.[20]

Automatic Disqualified Persons

The proposed regulations list categories of persons including organizations or entities, who are deemed to have "substantial influence" over the affairs of an organization, regardless of any additional surrounding facts and circumstances. This list includes people who have the power or influence to affect major decisions of an organization — whether or not they choose to exercise that power.

In this category are members of the organizations governing body who are entitled to vote. Presidents, chief executive officers (CEO), and chief operating officers — including persons with different titles who perform these functions — also are automatic disqualified persons. The regulations specify that a person performs the functions of a president, chief executive officer, or chief operating officer if that person "has or shares ultimate responsibility for implementing the decisions of the governing body or supervising the management, administration, or operation"[21] of the organization. If more than one person has these responsibilities, i.e., there is more than one CEO, all individuals with the responsibilities of a CEO are automatic disqualified persons.

In addition, treasurers and chief financial officers (CFO) — or any person who performs the functions of a treasurer or chief financial officer — are deemed to be disqualified persons. The proposed regulations define treasurer or chief financial officer as any person, regardless of title, who "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 authorizes electronic transfers of funds, from organization bank accounts."[22] As with CEOs, there may be more than one treasurer or CFO; if so, each will be an automatic disqualified person.

19. I.R.C. § 4958(f)(4) (citing § 4946(d)) (1998); Prop. Treas. Reg. § 53.4958-3(b)(1), 63 Fed. Reg. 41,486 (1998).

20. Prop. Treas. Reg. § 53.4958-3, 63 Fed. Reg. 41,498 (1998).

21. Prop. Treas. Reg. § 53.4958-3(c)(2), 63 Fed. Reg. 41,498 (1998).

22. Prop. Treas. Reg. § 53.4958-3(c)(3), 63 Fed. Reg. 41,498 (1998).

Finally, persons with a material financial interest in a provider-sponsored organization in which a tax-exempt hospital participates are deemed to be disqualified persons. These would include physicians who have a material financial interest in a physician-hospital organization or a preferred provider network that includes a § 501(c)(3) or § 501(c)(4) tax-exempt hospital.[23]

Persons Who Are Deemed Not To Be Disqualified Persons

The proposed regulations are helpful in that they include two categories of persons who are deemed *not* to be disqualified persons — regardless of the surrounding facts and circumstances.[24] The first category is other public charities described in § 501(c)(3) and exempt under § 501(a). The second category is significant for smaller organizations; it excludes employees:

- who receive total economic benefits from the organization of less than the amount of compensation that causes someone to be a "highly compensated employee" under the Code, i.e., approximately $80,000 per year for 1998;[25]
- who are neither automatic disqualified persons (such as a member of the board, CEO, or CFO) nor family members (or thirty-five percent controlled entities) of an automatic disqualified person;[26] and
- who are not "substantial contributors" to the organization. "Substantial contributor" is defined as someone whose contributions exceed both $5,000 and two percent of the organization's total contributions to date.[27]

The examples clarify that the $80,000 threshold applies to the total value of compensation plus any other economic benefits received from the organization. Thus, for example, a person who receives a salary of less than $80,000 per year for services rendered to the charity, but also sells property to the charity for a payment exceeding $20,000, does not qualify for the automatic non-disqualified person treatment if the organization's total combined payment for salary and the property exceeds $80,000.[28]

23. This result is largely compelled by § 501(o) of the Code, which declares that such persons are private shareholders or individuals with respect to the organization. Paying unreasonable compensation to such a person or engaging in a non-fair market value transaction for that person's benefit would constitute inurement. The definition of what constitutes an excess benefit transaction is built on the inurement standard, and Congress expressed an expectation that what is inurement under § 501(c)(3) would constitute an excess benefit transaction under § 4958. H.R. Rep. No. 104-506, at 59 (1996).

24. Prop. Treas. Reg. § 53.4958-3(d), 63 Fed. Reg. 41,498 (1998).

25. Prop. Treas. Reg. § 53.4958-3(d)(2)(A), 63 Fed. Reg. 41,498 (1998).

26. Prop. Treas. Reg. § 53.4958-3(d)(2)(B), 63 Fed. Reg. 41,498 (1998).

27. Prop. Treas. Reg. § 53.4958-3(d)(2)(C), 63 Fed. Reg. 41,498 (1998).

28. Prop. Treas. Reg. § 53.4958-3(d)(2)(A), 63 Fed. Reg. 41,498 (1998).

Facts and Circumstances Test

In all cases other than those where a person is deemed automatically either to be or not to be a disqualified person, the proposed regulations apply a "facts and circumstances" test to determine a person's status.[29] The regulations provide a non-exclusive list of facts and circumstances tending to show whether a person has substantial influence over an organization. Factors' tending to show a person has substantial influence include the following:

- the person is a founder of the organization;
- the person is a substantial contributor to the organization;
- the person receives compensation based on revenues from activities that the person controls;
- the person has authority to control a "significant portion" of the capital expenditures, operating budget, or compensation of employees of the organization;
- the person has managerial authority or is a "key advisor" to a person with managerial authority;
- the person owns a controlling interest in an entity that is a disqualified person.[30]

Again, these are factors to be considered; they are not an all-inclusive test.

The regulations also cite certain facts and circumstances' tending to show a person lacks substantial influence. They include the following:

- the person has taken a vow of poverty as an employee or agent of a religious organization;
- the person is an independent contractor, such as an attorney or accountant, acting in that capacity and without a potential economic interest in the transaction being questioned (other than receipt of fees for professional services);[31]
- if the person is a contributor, the person receives only such preferential treatment as is available to any other donor making a comparable contribution as part of a solicitation designed to attract a substantial number of contributions.[32]

There are ten examples provided to illustrate the application of all three categories.

29. Prop. Treas. Reg. § 53.4958-3(e)(2), 63 Fed. Reg. 41,498 (1998).

30. Prop. Treas. Reg. § 53.4958-3(e)(2)(i)-(vi), 63 Fed. Reg. 41,499 (1998).

31. It should be noted, however, that the independent contractor factor does not apply if the person is advising the organization with respect to a transaction that might economically benefit him or her, either directly or indirectly, aside from fees received for professional services rendered.

32. Prop. Treas. Reg. § 53.4958-3(e)(3)(i)-(iii), 63 Fed. Reg. 41,499 (1998).

No Initial Transaction Exception

The proposed regulations clearly omit an "initial transaction exception," commonly referred to as the "first bite rule." Such a rule would have declared that a person who has no existing relationship with an organization cannot become a disqualified person as a result of negotiating an initial agreement with the organization. Comments submitted prior to the release of the proposed regulations argued in favor of such a rule on the ground that a person generally does not have "substantial influence" over an organization prior to execution of this first agreement.

The proposed regulations have directly rejected that position in providing no exception for payments made under a contract that was signed at a time the recipient did not yet have substantial influence over the affairs of the organization.[33] Thus, although an individual may not have substantial influence over the organization on the day his contract is signed making him the CEO, he will be a disqualified person by the time payments are made under the contract. This position again increases the importance of adopting sound policies and procedures for negotiating and approving compensation and other arrangements not only with persons who clearly are disqualified persons but also with people who are likely to become disqualified persons in the future.

Application to Colleges and Universities

Colleges and universities will have a number of disqualified persons, including all of the voting members of their governing boards, their presidents or chancellors, and their chief financial officers. The examples in the proposed regulations apply the facts and circumstances test in ways that could bring many people under the disqualified person category. One of the examples concludes that the dean of a law school is a disqualified person with respect to the university of which the law school is part. Even though the dean has direct managerial authority over only the law school, the example reasons that because the university relies on the law school's reputation to attract students, alumni support and other grants, the dean has substantial influence over the entire university. The example suggests that other key figures who manage a part of a university's operations, such as the coach of a nationally known athletic team or the prize-winning researcher at a medical school, may be disqualified persons. Facts like reputation, importance in fund-raising, and relative clout within a large institution will vary tremendously individual to individual and school to school.

Another example in the proposed regulations concludes that a substantial contributor to a repertory theater company does not have substantial influence over the company even though the size of her donation entitles her to special privileges, like an invitation to a special opening night function or a

33. It has been observed that the Tax Court's decision in *United Cancer Council v. Commissioner*, 109 T.C. 326 (1997), provides support for the view that a person can gain substantial influence from an initial transaction. However, that decision was recently reversed by the Seventh Circuit and remanded for further consideration.

special number to call for ticket exchanges. The example relies on the fact that similar privileges were given to other contributors at the same or higher levels. It is helpful in removing any fear that a standardized donor recognition program will cause lots of generous contributors to become disqualified persons. However, colleges and universities with sophisticated development programs trying to secure large and unusual gifts may wish to offer unusually generous treatment to donors in return. In these cases, the proposed regulations raise a question as to whether providing uniquely attentive treatment to the very largest donors will suggest that the donors have substantial influence and cause them to be classified as disqualified persons.

Colleges and universities that run hospitals will be interested in the two examples that evaluate whether doctors on hospital staffs have substantial influence over the hospital. One concludes that a staff physician with no special managerial authority is not a disqualified person. However, another concludes that the chairman of a department responsible for a principal part of the hospital's revenues who has authority over the department's budget and the bonuses paid to fellow doctors in the department does have substantial influence over the hospital. If the hospital is part of a university and not a separate legal entity, further analysis would be required, similar to that used for the law school dean in the example described above, to determine whether the doctor is a disqualified person with respect to the university.

However concrete certain aspects of these tests appear to be, when applied to complex institutions like colleges and universities, it will be very difficult to know in advance who all of the disqualified persons are within the institution. The facts and circumstances test makes the uncertainty even greater. For example, institutions may have a number of boards, councils or committees with differing degrees of authority over institutional affairs. Voting members of the principal board are clearly disqualified persons under the proposed regulations, but members of other councils or committees may need to be considered as well. Institutions that have multiple campuses will need to ask whether they have someone who meets the definition to be a CEO and CFO on each campus and whether each of these individuals is a disqualified person with respect to the entire institution. As the American Insitute of Certified Public Accountants (AICPA) has noted in its comments, knowing who is a substantial contributor to a large and old institution, like a college or university, can be very difficult. The AICPA recommended revising the test for substantial contributors in the regulations to include only persons who have contributed more than two percent of the organization's total support during the year in which the potential excess benefit transaction occurs and the three preceding years.

The proposed regulations add specificity but do not eliminate the ambiguity inherent in the statutory definition of disqualified person. Therefore, colleges and universities will want to place an even greater emphasis on having sound practices and procedures designed to monitor that the school is not paying excess compensation or more than fair market value in its transactions with anyone who is or might be a disqualified person.

EXCESS BENEFIT TRANSACTIONS

Fundamentally, intermediate sanctions are a tax on excess benefit transactions. Therefore, the definition of "excess benefit transaction" lies at the heart of the scheme. Under § 53.4958-4 of the proposed regulations, an "excess benefit transaction" includes "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit."[34] Payment of an amount that is more than reasonable compensation for services or more than fair market value for property will result in an excess benefit transaction if the excess is being provided to a disqualified person.

The regulations state that an excess benefit may be provided to a disqualified person directly or indirectly through an entity "controlled by or affiliated with" the applicable tax-exempt organization, such as a taxable subsidiary. The key regulatory concern appears to be whether the applicable tax-exempt organization has caused the excess benefit to be delivered through the controlled or affiliated organization. The proposed regulations make specific reference to a parent organization that engages in an excess benefit transaction when it "causes" its subsidiary to pay excessive compensation to someone who is a disqualified person of the parent.[35]

The proposed regulations imply that there will not be an excess benefit transaction if a subsidiary or an affiliate of an applicable tax-exempt organization pays excessive compensation to one of the organization's disqualified persons without the knowledge or participation of the tax-exempt organization. Nevertheless, the proposed regulations put organizations on notice that transactions with their subsidiaries and affiliates may be excess benefit transactions in certain cases. Therefore, to the extent an institution has the capacity to direct the action taken by its affiliate or subsidiary, including through the action of overlapping boards, it should be sure the same practices and procedures are being applied for the affiliate or subsidiary's transactions as the institution applies to its own direct transactions.

Reasonable Compensation and Fair Market Value

The standard for determining what is reasonable compensation for services is the same used for years in determining whether compensation is reasonable and, therefore, deductible as a business expense under § 162 of the Code.[36] Accordingly, the regulations provide that compensation is reasonable only if the amount paid "would ordinarily be paid for like services by like enterprises under like circumstances."

34. Prop. Treas. Reg. § 53.4958-4, 63 Fed. Reg. 41,500 (1998).

35. Prop. Treas. Reg. § 53.4958-4(a)(2), 63 Fed. Reg. 41,500 (1998).

36. *See* Treas. Reg. § 1.162-7(b)(3) (1960). The House Report accompanying the intermediate sanctions legislation stated that existing tax law standards would apply in determining reasonableness of compensation. H.R. REP. No. 104-506, at 56 (1996).

In determining the reasonableness of compensation, all items of compensation must be considered, including salaries, bonuses, deferred compensation that is both earned and vested, severance payments, and all fringe benefits (except § 132(d) "working condition fringe benefits" and § 132(e) "de minimis fringe benefits").

Similarly, the standard for fair market value is also based on the longstanding definition used for purposes of the § 162-business expense deduction. Thus, fair market value is the price at which property or the right to use property would change hands between a willing buyer and a willing seller.[37]

For purposes of determining what compensation a willing buyer would pay a willing seller, generally the circumstances existing at the time the contract to pay compensation becomes binding are taken into account, not those in existence at the time compensation is actually paid. Institutions should note that if a contract provides for termination or cancellation at will at the end of a particular term, and the institution elects to continue the contract, an agreement will be considered new as of the date the termination or cancellation would have taken effect.[38]

Thus, the circumstances in existence at what would have been the termination date become relevant rather than the circumstances in existence when the contract was originally negotiated and signed. However, the rules are slightly different for contracts with significant contingencies. The proposed regulations indicate that where contingencies make it impossible to determine reasonableness of compensation under a contract based on circumstances existing at the date the contract for services was made, the reasonableness determination will be made based on all facts and circumstances beginning at the time the contract becomes binding up to and including circumstances existing on the date of payment.

If an excess benefit transaction occurs, it takes place on the date on which the excess benefit is received for federal income tax purposes.[39] This rule has important consequences for contracts that extend over a long period of time. First, if a payment under a long-term contract is determined to be an excess benefit transaction, the organization risks engaging in additional excess benefit transactions when it makes subsequent contractual payments unless it modifies the terms of the agreement.[40]

Such a modification is clearly in the best interest of the institution, but it may be difficult to accomplish once a contractual liability to the other party has been established. Therefore, institutions may wish to preserve their ability to amend extended agreements in response to issues arising under the intermediate sanctions rules. Second, if an institution enters into a long-term

37. Prop. Treas. Reg. § 53.4958-5(b)(2), 63 Fed. Reg. 41,503 (1998).

38. Prop. Treas. Reg. § 53.4958-1(g)(2), 63 Fed. Reg. 41,497 (1998).

39. Prop. Treas. Reg. § 53.4958-1(e), 63 Fed. Reg. 41,493 (1998).

40. The preamble to the proposed regulations specifically alerts organizations to this possibility. It notes that correction of an excess benefit transaction occurring under an extended contract does not necessarily require cancellation of the contract. Rev. Proc. 98-45, 1998-34 I.R.B. 12. However, the contract may have to be modified or cancelled in order to avoid future excess benefit transactions.

contract that is subject to a contingency, there may be a long gap in time between the time the contract becomes binding and the time payment is made and the circumstances that will affect the reasonableness determination are established. A contract that may have been reasonable under certain assumptions when negotiated may not be reasonable by the time the contingency is resolved, leaving the institution vulnerable to participation in an excess benefit transaction. In light of this possibility, institutions will want to think very carefully before including unpredictable contingencies in contracts with long terms.

Treatment of Fringe Benefits

Although working condition fringe benefits and de minimis fringe benefits are excluded from compensation for purposes of intermediate sanctions, a number of fringe benefits that are excluded from the employee's income for income tax purposes are included in compensation for intermediate sanctions purposes. To see this difference, consider the president of a university who is required to live on campus in a specific house. The housing is provided rent-free. Under the institution's tuition remission plan, the president's two children are attending the institution as undergraduates free of charge. The president is not required to include the value of the housing in income for income tax purposes because it is qualified campus lodging described in § 119 of the Code. The tuition remission is also excluded from the President's income under § 117(d) of the Code. However, the institution would be required to include the value of both of those items in the President's compensation for purposes of determining whether the president's compensation resulted in an excess benefit transaction.

Timing questions also arise in connection with deferred compensation arrangements. The proposed regulations require the inclusion of deferred compensation that is "earned and vested." However, under § 457 of the Code, deferred compensation, if properly structured, is not included in the employee's income while there exists a "substantial risk of forfeiture." What happens if the president's right to receive the deferred compensation is fully earned and vested because of his years of service, but the funds that may be used to cover the deferred compensation liability are subject to claims of the university's creditors? The proposed regulations include the deferred compensation in the president's compensation for intermediate sanctions purposes as soon as it is earned and vested even though it will not be included in his income for income tax purposes until the substantial risk of forfeiture is eliminated.

Specific statutory rules to determine the tax treatment of certain benefits have been developed over time. The specific exclusions avoid the necessity of allocation between the business component of the benefit and the personal component of the benefit, as well as the difficult factual inquiry into whether the expense is sufficiently business-related to be excludable as a working con-

contract that is subject to a contingency, there may be a long gap in time between the time the contract becomes binding and the time payment is made and the circumstances that will affect the reasonableness determination are established. A contract that may have been reasonable under certain assumptions when negotiated may not be reasonable by the time the contingency is resolved, leaving the institution vulnerable to participation in an excess benefit transaction. In light of this possibility, institutions will want to think very carefully before including unpredictable contingencies in contracts with long terms.

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In the alternative, commentators have suggested following the model that is in the private foundation rules under § 4941 which divides insurance and indemnification into two categories, compensatory and non-compensatory.[45] Only the compensatory portion, that is the portion that covers fines, penalties, taxes or liabilities for willful acts or omissions, is included in compensation for purposes of determining whether compensation is reasonable.

Disregarded Benefits

Although the proposed regulations generally articulate a highly inclusive definition of compensation, certain categories of benefits are explicitly disregarded for purposes of determining whether an excess benefit has been provided. As noted above, working condition fringe benefits and de minimis fringe benefits are disregarded. The proposed regulations also specifically call for disregarding reimbursements to members of the organization's governing body for reasonable expenses incurred when attending meetings of the governing body. The proposed regulations state that "reasonable expenses" for this purpose do not include expenses for "luxury travel" or "spousal travel." This provision appears to be technically flawed because it is unclear how to reconcile it with the provision that disregards all working condition fringe benefits. Under the working condition fringe benefit rules of § 132(d), payment of travel expenses is generally excludable as a working condition fringe benefit if the travel is related primarily to the taxpayer's trade or business and the expenses are not lavish and extravagant.[46] Reimbursements for spousal travel are generally excludable as working condition fringe benefits if "the spouse's . . . presence on the employee's business trip has a bona fide business purpose" and the employee properly substantiates the travel.[47] Furthermore, the rules serve to exclude from income working condition fringe benefits provided not only to employees but also to bona fide volunteers.[48] Thus, the proposed regulations appear to be giving conflicting instructions: travel reimbursements for board members are to be disregarded as long as they are not for lavish or extravagant expenses, but are to be included if the travel is "luxury travel;" spousal travel reimbursements are to be disregarded if the spouse is serving a bona fide business purpose on the trip, except that they are to be included no matter what the conditions of travel.

If the explicit limitations on disregarding reimbursements for luxury travel rather than the working condition fringe benefit rule were to be applied, it would create a fair amount of confusion because there is no crisp definition of "luxury travel." For example, if a college or university invites the members of its board to a national sports championship in which the institution is competing, has them attend a business meeting while they are there, and

45. Treas. Reg. § 53.4941(d)-2(f)(3) and (4) (1998).

46. I.R.C. § 162(a)(2) (1986); Treas. Reg. § 1.162-2(b) (1968); Treas. Reg. § 1.132-5(a)(1) (1989).

47. Treas. Reg. § 1.162-2(c) (1968); Treas. Reg. § 1.132-5(t)(1) (1989).

48. Treas. Reg. § 1.132-5(r) (1989).

houses them at the same hotel where the team is staying, it is unclear whether the reimbursements made to the board members for their travel expenses can be disregarded. Does it matter what quality of service is at the hotel? Whether the hotel is classified as a "luxury" hotel in travel guides? Whether the price doubles for the weekend of the championship because of the demand for rooms? In the case of spousal travel, could the travel reimbursement for a board member's spouse be disregarded if the institution asked the spouse to accompany the board member to an alumni fundraising event and specifically asked the spouse to solicit particular alumni for donations?

A number of comments have been submitted suggesting possible clarifications as to when travel reimbursements for board members may be disregarded. They tend to advocate following the existing standards for working condition fringe benefits. For example, the American Council on Education has recommended that travel reimbursements be disregarded unless they violate the "lavish or extravagant" expenses standard used in § 162 and § 274.[49] The Association of the Bar of the City of New York has recommended that reimbursements for spousal travel be disregarded at least where the spouse is performing specific duties at the request of the organization and on its behalf.[50] That change would be consistent with the rules described above that apply when determining whether spousal travel constitutes an excludable working condition fringe benefit for an employee. The AICPA has suggested that travel reimbursements be disregarded not only for members of the governing board attending meetings but also for members of other duly constituted committees meeting in an official capacity to conduct business for the organization. That suggestion would also be consistent with the working condition fringe benefit rules.

An alternative suggested by the District of Columbia Bar Section of Taxation may also be helpful. It suggested a safe harbor under which travel expense reimbursements would be disregarded if a federal employee would have been authorized under federal travel rules to be reimbursed for the same expense.[51] The federal travel rules establish per diems for travel to specific cities and circumstances under which employees may travel business class or first class. Adopting such a safe harbor would provide greater certainty, but the conflict with the working condition fringe benefit rules would still need to be resolved.

49. Comments on Proposed Regulations Issued Under Section 4958 of the Internal Revenue Code, submitted by Sheldon Elliot Steinbach, Vice President and General Counsel, American Council on Education, Washington, D.C., Nov. 4, 1998.

50. Comments on the IRS Proposed Rules (REG-246256-96) Imposing Excise Taxes on Transactions Providing Excess Benefits to Disqualified Persons of Charitable Organizations, submitted by the Committee on Nonprofit Organizations of the Association of the Bar of the City of New York, Oct. 30, 1998.

51. Comments on Two Aspects of the Proposed "Intermediate Sanctions" Regulations Issued Under Section 4958 of the Internal Revenue Code, submitted by Cynthia M. Lewin and Barbara L. Kirschten on behalf of the Section on Taxation of the District of Columbia, Nov. 2, 1998.

Until final regulations are published and this technical issue is resolved, institutions will want to exercise some caution when paying for board members' travel expenses. The rule limiting the travel reimbursements that are disregarded reflects a concern that travel reimbursements above a certain level may serve as a vehicle for delivering improper personal benefits to disqualified persons. For the time being, an organization can most easily benefit from the exception that clearly applies to most travel reimbursements by following an explicit travel reimbursement policy that identifies the business purpose for each trip, for the mode of travel and, where applicable, for the inclusion of spouses. Throughout the proposed regulations the drafters have emphasized the importance of adhering to sound procedures and documentation, and this is an instance where applying that general principle could prove to be very valuable.[52]

The proposed regulations also disregard economic benefits provided to a disqualified person solely in the person's capacity as a member of or volunteer for the organization for purposes of determining whether compensation is unreasonable. In the case of membership benefits, the same benefits must be provided to members of the public for a membership fee of seventy-five dollars or less per year. Examples of typical membership benefits are advance ticket purchase privileges, free parking and gift shop discounts. However, benefits provided to donors who contribute a specified amount which is more than seventy-five dollars are not disregarded, and therefore could qualify as "excess benefits" under the general test described above if provided to a disqualified person. The IRS and Treasury solicited comments as to whether the seventy-five-dollar ceiling was too low, suggesting that they would be willing to increase it if given an appropriate rationale.

Finally, benefits provided to a disqualified person solely as a member of a charitable class served by the organization in furtherance of its exempt purpose are disregarded for § 4958 purposes. An example might be inclusion of a disqualified person's family member in a clinical trial of a new medical treatment provided the individual was selected according to the same scientific criteria used to select the rest of patients. Another example might be a scholarship awarded to the child of an employee who met the criteria for financial need and academic merit generally applied by the institution in awarding such aid.

Revenue-Sharing Transactions

Congress directed the IRS and Treasury to write regulations defining when certain "revenue-sharing" transactions result in inurement and, consequently, are excess benefit transactions. Such revenue-sharing transactions were to be proscribed in addition to transactions in which a disqualified person receives an economic benefit in excess of the value of the benefit he or she provides in return. In response to this direction, the proposed regulations provide a facts

52. Defining an explicit travel reimbursement policy not only will help organizations make justifiable decisions about particular reimbursement requests, the documentation will also bolster their ability to defend their practice in the event of IRS review.

and circumstances test for determining whether inurement results from a transaction in which the economic benefit provided to a disqualified person is based on the revenues of one or more of the organization's activities. For these purposes, the proposed regulations do not distinguish between gross and net revenues.[53]

"Proportionality" Requirement

The regulations state that a revenue-sharing transaction may constitute an excess benefit transaction resulting in penalties 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 purpose." The regulations specify that the relationship between the size of the benefit provided and the quality and quantity of the services provided in exchange is relevant in determining whether proportionality has been achieved.[54] Second, the regulations state that the ability of the disqualified person to control the activities generating the revenues on which his or her compensation is based is relevant to the determination of whether proportionality is maintained.[55]

The proportionality test has not been previously articulated and has raised a number of questions in written comments. The American Hospital Association has questioned whether quantity or quality of benefit measures the proportionality. It recommends that the proposed regulation be clarified by focusing on the alignment of incentives exclusively in the service of exempt purposes that appears to be the key determinant in the examples. The American Council on Education (ACE) has argued that as long as the amount of compensation provided is reasonable, the structure of the arrangement should not cause the payment to be an excess benefit transaction. The Health Law Section of the Michigan State Bar takes a similar view, saying only so much of a payment as is in excess of reasonable compensation should be treated as an excess benefit. ACE also notes that the terms of the proposed regulation would cause clearly proportional arrangements made as part of an unrelated trade or business activity to be excess benefit transactions. For example, paying a commission to someone selling advertising in an organization's journal would be an excess benefit transaction, a result ACE believes is not legally supportable.

Despite the lack of clarity on these points, the regulations do offer three examples to illustrate this rule, two of which are especially helpful to colleges and universities. In one example, an organization's investment manager receives a bonus equal to a percentage of any increase in the value of the organization's investment portfolio. Because the bonus gives the manager an incentive to provide high-quality services, and because the organization will receive benefits proportional to any benefit the manager receives, i.e., for every $X the manager gets, the organization gets a multiple of $X, the con-

53. Prop. Treas. Reg. § 53.4958-5(a), 63 Fed. Reg. 41,486 (1998).
54. *Id.*
55. *Id.*

tract does not result in an excess benefit transaction under the special rules for revenue-sharing transactions.[56] For colleges or universities with large investment portfolios seeking to compete with private investment firms for talented managers, this example should prove helpful in establishing that certain types of revenue-based compensation are entirely permissible.

Another helpful example involves a university professor who develops a patentable invention while working for the university. Under his employment arrangement, the patent becomes the university's sole property. The university alone decides how the patent it to be used, but it is required to give the professor a percentage of any royalties it earns from the patent. The example concludes that this is not an excess benefit transaction under the special rule for revenue-sharing transactions.[57] Obviously, this last example will be of great interest and comfort to colleges and universities because patent arrangements of this type are reasonably common.

A contrasting example involves the manager of an organization's gambling operation. The example concludes that the revenue-sharing arrangement is an excess benefit transaction. Under the agreement, the charity collects a fixed percentage of the net profits while the manager collects both the operating expenses and the remainder of the net profits. Therefore, the manager benefits from the profit built into the operating expenses regardless of whether the net profits from the gambling operation are high or low. The charity benefits only to the extent there are net profits, not in proportion to the benefits that the manager collects. The manager controls all aspects of the operation generating the revenues, including the expenses, and has no incentive to maximize the benefits to the charity.

Some of the situations that are most difficult to evaluate under the revenue-sharing portion of the proposed regulation involve incentive compensation. Questions are being raised about the permissibility of long-used profit-sharing plans to the relatively new practice of "gain-sharing" that some health care organizations are adopting for doctors. Treasury and the IRS may try to resolve some of this ambiguity in drafting its final regulations given how common incentive compensation has become.

Fair Market Value Not Relevant

The regulations specifically provide that, for purposes of determining whether a revenue-sharing transaction results in inurement, it is not relevant whether the disqualified person ultimately receives only fair market value for the benefits he or she provides the organization in return. The revenue-sharing provisions of the proposed regulations thus concern the structure of arrangements, not their results. If the basic revenue-sharing structure permits the disqualified person to receive benefits disproportionate to the benefits he or she provides in return, the arrangement is per se an excess benefit transaction.[58]

56. Prop. Treas. Reg. § 53.4958-5(d), example 1, 63 Fed. Reg. 41,486 (1998).
57. Prop. Treas. Reg. § 53.4958-5(d), example 3, 63 Fed. Reg. 41,486 (1998).
58. Prop. Treas. Reg. § 53.4958-5(a), 63 Fed. Reg. 41,486 (1998).

The logical result of this focus on structure rather than fair market value is that the "excess benefit" in an improper revenue-sharing transaction is the entire benefit provided to the disqualified person under the transaction — not just the portion of the benefit which exceeds the fair market value of the benefit provided in return. Commentators have noted that under this "all or nothing" approach, it is unclear how an organization ever could "correct" an improper revenue-sharing transaction, particularly when the disqualified person has provided valuable services under a contract enforceable under state law. It would be important to know whether correction would occur if the organization reforms the contract and pays a similar amount under a different structure that does not provide for improper revenue sharing.

Prospective v. Retroactive Application

The proposed regulations provide that the section on revenue-sharing arrangements will apply only to revenue-sharing transactions that occur on or after the date of publication of final regulations. However, the date a transaction occurs — as defined by the proposed regulations — may well occur significantly after an arrangement for revenue sharing is made. For example, if an organization enters into a revenue-sharing arrangement before the issuance of final regulations that provides disproportionate benefits to a disqualified person which the disqualified person will not receive until after the publication of final regulations, the arrangement will be subject to the revenue-sharing restrictions, even though the contract was signed prior to the publication of final regulations.[59]

Anticipating the desire for more specific guidance, the IRS has specifically requested comments on the revenue-sharing provisions of the proposed regulations.

Intent to Treat Item as Compensation

The intermediate sanctions statute explicitly provides that amounts paid by an applicable tax-exempt organization will not be considered compensation for services unless the organization has clearly demonstrated its intent for the payment to serve as compensation.[60] The proposed regulations state that the organization must demonstrate its intent by providing "clear and convincing evidence that it intended to so treat the economic benefit when the benefit was paid."[61] In the absence of such clear and convincing evidence, the item will not be treated as provided in consideration for services — with the usual result that it will be an excess benefit if paid to a disqualified person.

The regulations provide that reporting a benefit as compensation on a Form W-2, 1099, or 990, prior to the commencement of an audit, constitutes clear and convincing evidence of intent to treat the benefit as compensation. Alternatively, if the recipient reports the benefit as income on his or her

59. Prop. Treas. Reg. § 53.4958, 63 Fed. Reg. 41,486 (1998).
60. I.R.C. § 4958(c)(1)(A) (1998).
61. Prop. Treas. Reg. § 53.4958-5(c), 63 Fed. Reg. 41,502 (1998).

Form 1040, that return will constitute clear and convincing evidence of intent to treat the benefit as compensation. An organization that fails to file a required information return may still establish clear and convincing evidence of intent to treat an item as compensation by showing that the failure to report the item as such was due to what IRS rules would consider "reasonable cause." Reasonable cause can be shown by establishing that there were significant mitigating factors with respect to the failure to report, or that the failure resulted from events beyond the organization's control, and the organization acted in a reasonable manner to correct the problem upon its discovery.

The regulations also provide that documentation other than tax returns may provide clear and convincing evidence that a payment was intended as compensation. For example, if a covered organization contracts with a corporation to perform services, the service contract provides clear and convincing evidence that the payments under the contract are intended as compensation for services.[62] Payments to the corporation need not be reported to the IRS on an information return, but the contract establishes intent in this case just as effectively as an information return would.

Application to Colleges and Universities

As large complex institutions, colleges and universities will enter into a wide array of transactions that need to be evaluated as potential excess benefit transactions. Smaller charities with fewer employees and less diverse activities may avoid many of the issues colleges and universities will necessarily face. Also, given increasing pressures to hold college costs down, institutions must become more innovative in structuring compensation arrangements to produce more efficient results. These innovations will likely present questions under the revenue-sharing restrictions.

The many factors that go into identifying an excess benefit transaction mean that many transactions will have at least some potential to be excess benefit transactions and identifying the smaller group that are likely to fit the definition will be challenging. To illustrate the analysis involved, consider a college or university that has had a food service contract for years with the same vendor. The relationship has been very satisfying, and the university has placed the head of the vendor company, who is also an alumnus, on the board of directors. When it comes time to renew the food service contract, the institution's procurement officer negotiates the contract with the head of the vendor. The contract contains a provision that rewards the vendor for cost savings by allowing the vendor to keep a portion of any costs saved over the previous year.

In order to determine whether the contract will result in an excess benefit transaction, the institution needs to know whether the vendor is itself a disqualified person because of the degree of the board member's ownership. If so, payments under the food service contract may be excess benefit transac-

62. Prop. Treas. Reg. § 53.4958-5(c)(2)(iii), 63 Fed. Reg. 41,502 (1998).

tions if the contract pays more than reasonable compensation for services or fair market value for goods, or if the cost savings incentive is considered impermissible revenue-sharing. Even if the scope of the board member's ownership does not make the company a disqualified person, the institution must still consider whether there are other facts and circumstances that give the vendor substantial influence over the school. If the vendor is not a disqualified person, the institution will still have to consider whether the contract could indirectly benefit the board member — who is automatically a disqualified person.

Assuming such an indirect benefit is possible, the institution has to determine whether the board member is receiving more than reasonable compensation for services or fair market value for property or an inappropriate share of revenue. This contract will be only one of thousands of contracts for goods and services the institution negotiates each year. Specialized analysis for all but the largest and most unusual transactions will be impractical. Therefore, in order to get the best protection possible from an intermediate sanctions tax, institutions will want to follow the steps established below for invoking the rebuttable presumption whenever a person who is, or is likely to be, a disqualified person stands to receive any kind of benefit from a transaction with the institution.

Rebuttable Presumption that a Transaction is Not an Excess Benefit Transaction

Consistent with the legislative history of § 4958, the regulations provide a rebuttable presumption that compensation paid is reasonable, and consideration paid for property transfers is the fair market value, if the decision-making process with respect to the compensation arrangement or property transfer follows prescribed procedures.[63] This is an important safeguard for organizations. Even if the presumption were not specifically provided in the regulations, the prescribed procedures represent "best practices" that should be followed when entering into any compensation arrangement or property transfer involving a disqualified person. The presumption applies if three procedural requirements are met: (1) the arrangement is approved by members of the organization's governing body or a committee thereof, none of whom have a conflict of interest with respect to the transaction; (2) the governing body or committee obtained and relied upon appropriate data as to comparability or fair market value; and, (3) the governing body, or committee adequately and contemporaneously documented the basis for its determination.

Approval by an Independent Board or Committee

In order to satisfy the first prong of the rebuttable presumption test, the board or committee approving the arrangement must consist solely of individuals who have no conflict of interest with respect to the arrangement in

63. Prop. Treas. Reg. § 53.4958-6, 63 Fed. Reg. 41,503-05 (1998).

question. The regulations clarify that if regular members of a board or committee have conflicts, the board or committee can still give the necessary approval provided that the conflicted members recuse themselves from deliberation and voting. Any conflicted directors may meet with other members of the group to answer questions about the transaction, but then must leave the room prior to debate and voting on the proposal.

The proposed regulations also provide guidance as to when a member of a board or committee has a conflict of interest.[64] Obviously, a member of a board who is a disqualified person benefiting from a transaction in question has a conflict of interest. Beyond that, persons who are related to a disqualified person and those who economically benefit from or have a material financial interest affected by the transaction, have conflicts. Further, individuals in employment relationships subject to the direction or control of such a disqualified person, or who receive compensation or other payments subject to the approval of the disqualified person, are considered to have conflicts. Finally, anyone who participates in a reciprocal arrangement — approving a transaction for the benefit of a disqualified person who has or will approve a transaction for the individual's benefit — has a conflict of interest.

Approval by a board-appointed committee will satisfy this first requirement if the committee is authorized to act on behalf of the organization by state law. If the committee's actions must be ratified by the full governing body in order to be effective, the committee's actions cannot be relied upon for purposes of fulfilling the first element required for the presumption. In that situation, to earn the presumption, members of the full board approving the committee's actions cannot include anyone with a conflict of interest.

If state law permits, members of the committee approving the transaction on behalf of the organization may be persons who are not members of the full board. However, members of the committee whose action is relied upon in claiming application of the rebuttable presumption are deemed to be organization managers for purposes of the organization manager tax — regardless of whether they otherwise serve as members of the board or officers of the organization.

Appropriate Data

The proposed regulations provide that the board or committee approving the transaction must have appropriate data as to comparability. Relevant information includes, but is not limited to: (1) compensation paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; (2) the availability of similar services in the area; (3) "independent compensation surveys compiled by independent firms;"[65] (4) actual written offers from similar organizations competing for the disqualified person; and (5) if the transaction involves the transfer of property, in-

64. Prop. Treas. Reg. § 53.4958-6(d)(iii), 63 Fed. Reg. 41,504 (1998).
65. Prop. Treas. Reg. § 53.4958-6(d)(iv)(2)(i), 63 Fed. Reg. 41,504 (1998).

dependent appraisals of that property.[66] The proposed regulations include a special rule intended to make compliance with this element of the presumption easier for small organizations.[67] When approving compensation arrangements, organizations with annual gross receipts of less than $1 million may rely on data as to "compensation paid by five comparable organizations in the same or similar communities"[68] for similar services. For this purpose, an organization's annual gross receipts are determined on a rolling average of the three prior taxable years. Organizations related by common control or by their governing documents must be aggregated to determine whether this special rule is available. The proposed regulations state clearly that no inference is to be drawn from this safe harbor as to the number of comparables otherwise necessary to constitute appropriate data. Fewer than five may be ample.

Contemporaneous Documentation

In order to satisfy the third prong of the rebuttable presumption test, the organization must maintain adequate contemporaneous documentation of the approval process. The proposed regulations make it clear that the documentation must be contemporaneous with the approval of the transaction — for such a decision to be documented concurrently, records must be prepared by the next meeting of the board or committee and must be reviewed and approved "within a reasonable time period thereafter."[69] After-the-fact documentation will not be sufficient to claim the presumption.[70] The substance of the documentation must also be adequate. The written or electronic records of the board or committee approving the transaction must note: (1) the terms of the transaction and the date it was approved; (2) the members of the board or committee who were present during debate and those who voted on it; (3) the comparability data obtained and relied upon and how the data was obtained; and (4) any actions taken by a regular member of the board or committee who had a conflict of interest. The board or committee must record the basis for any determination it then makes that reasonable compensation or fair market value is more or less than the range of comparable data. This last point is helpful. It clearly implies that compensation or payments for property that are above or below the documented comparables can be reasonable or constitute fair market value if there are clear objective reasons for the difference.

Delegation

The governing body may delegate responsibility for following the procedures necessary to give rise to the rebuttable presumption. The delegation must specify the procedures to be followed. If the designees do in fact follow

66. *Id.*
67. Prop. Treas. Reg. § 53.4958-6(d)(iv)(2)(ii), 63 Fed. Reg. 41,504 (1998).
68. *Id.*
69. Prop. Treas. Reg. § 53.4958-6(d)(3)(ii), 63 Fed. Reg. 41,505 (1998).
70. Prop. Treas. Reg. § 53.4958-6(d)(3)(i), 63 Fed. Reg. 41,505 (1998).

the procedures, their actions shall have the same effect as if the board had acted itself.[71] However, if the designees act, but their actions cannot take effect absent ratification by the full governing body, then the transaction is not treated as having been approved by the designees for purposes of the rebuttable presumption.[72]

Rebutting the Presumption

Meeting the three required elements gives the benefit of a presumption, but it leaves the IRS with the opportunity to rebut the presumption. The proposed regulations state that the IRS may rebut the presumption by "additional information showing that the compensation was not reasonable or that the transfer was not at fair market value."[73] The need to assemble "additional" information puts a significant burden on the Service because it requires the investment of scarce resources in new valuations or appraisals. The Association of the Bar of the City of New York has suggested that the IRS may rebut the presumption only if a "preponderance of the evidence" supports its view. That standard for ultimately resolving the question is implicit. A presumption cannot logically be overridden by evidence that is weaker than the evidence on which the presumption is based. Nevertheless, it could be made clearer in the final regulation.

A more likely problem involves not the standard for rebuttal but the standard for establishing the presumption initially. An organization may be reasonably certain that it has satisfied the first prong with respect to absence of conflict of interest, and the third prong with respect to documentation, but the proposed regulations appear to give the IRS the capacity to dispute satisfaction of the second prong on the grounds that the organization's comparable data is not "appropriate." The proposed regulations indicate that what constitutes appropriate data may vary with the knowledge and expertise of those reviewing it on behalf of the organization. The legislative history gives a list of illustrations of appropriate data, including items like independent compensation surveys or actual written offers, but says nothing more about what made the data appropriate.[74] The examples included in the proposed regulations reflect a concern about using data that is based on a wide variety of organizations or too much geographic variation. If there are no standards for the quality of the data being used, then the rebuttable presumption can become a procedural rubber stamp for avoiding intermediate sanctions. Nevertheless, the proposed regulations do present a dilemma where comparables are in short supply, where the position to be filled is unique or novel, or where there is a risk that the IRS may disagree about the appropriateness of the data that has been assembled.

71. Prop. Treas. Reg. § 53.4958-6(b), 63 Fed. Reg. 41,504 (1998).
72. Prop. Treas. Reg. § 53.4958-6(d)(iv), 63 Fed. Reg. 41,504-05 (1998).
73. Prop. Treas. Reg. § 53.4958-6(c), 63 Fed. Reg. 41504 (1998).
74. H.R. REP. No. 104-506, at 57 (1996).

Timing Is Critical

One difficulty with the rebuttable presumption as described in the proposed regulations is determining when a transaction is ripe for approval. The proposed regulations specify that the presumption cannot apply until circumstances exist so that reasonableness of compensation can be determined.[75] Thus, if a disqualified person is to receive a discretionary bonus of unknown amount, the reasonableness of his or her compensation cannot be determined — and the three procedural requirements of the presumption cannot be met — until the amount of the bonus is known. The exact application of this timing rule may be clarified in the final regulations.

Application to Colleges and Universities

The advantages stemming from the rebuttable presumption should persuade colleges and universities to adopt practices and procedures that will give rise to the presumption. First of all, in order to rebut the presumption, the IRS must introduce its own data on reasonable compensation and fair market value. Reliable data can be difficult and expensive to assemble; therefore, the IRS will likely save its resources to challenge the most suspicious transactions, preferring not to question those that have been subject to a thoughtful review within the organization. Second, the three prongs of the rebuttable presumption test — and especially the third requiring documentation — are designed to create a clear history that can be readily audited. If an agent can access that history quickly and understand the reasons for approving the transaction, the audit process can be amicable, swift, and less costly. Third, the rebuttable presumption enables institutions to respond methodically to the uncertainties inherent in intermediate sanctions.

With the identity of disqualified persons depending in many cases on facts and circumstances and the existence of excess benefit transactions depending on reasonable compensation and fair market value — elusive standards — it is impossible to know every instance where tax may potentially be imposed. Once the procedures necessary to invoke the rebuttable presumption become a regular part of institutional operations in as many scenarios as possible, the institution can efficiently and effectively avoid excess benefit transactions without having to perform board-level review of dozens of individual scenarios. Finally, the benefits extend beyond the federal tax consequences. As noted above, the elements necessary to establish the rebuttable presumption are "best practices" that will also help directors and officers ensure they are meeting their fiduciary obligations under state law.

Application of the Section 4958 Excise Taxes on Excess Benefit Transactions

As discussed in the overview, § 4958 of the Code imposes three separate taxes on excess benefit transactions: a first-tier tax paid by the disqualified person, a second-tier tax paid by the disqualified person in the case of failure

75. Prop. Treas. Reg. § 53.4958-6(e), 63 Fed. Reg. 41,505 (1998).

to correct the excess benefit transaction, and a tax paid by certain foundation managers.

First-Tier Tax Paid By Disqualified Persons

The first-tier tax on an excess benefit transaction is twenty-five percent of the excess benefit received. Except in the case of improper revenue-sharing arrangements, the excess benefit is the amount by which the value of the compensation or other benefits received by the disqualified person exceeds the fair market value of the services or property provided by the disqualified person. In a case of improper revenue sharing, the proposed regulations make the entire amount transferred an excess benefit. The disqualified person who benefits from the excess benefit transaction must pay the tax. If more than one disqualified person receives an excess benefit from a particular transaction, each such disqualified person is jointly and severally liable for the tax.

The Second-Tier Tax

If a first-tier tax is imposed on an excess benefit transaction and the transaction is not corrected within the "taxable period," the disqualified person must pay a second-tier tax equal to 200% of the excess benefit. The taxable period begins on the date the transaction occurs and ends when a notice of deficiency with respect to the first-tier tax is mailed or when the first-tier tax is assessed, whichever is earlier.

Correction

Correcting an excess benefit transaction requires undoing the excess benefit to the extent possible and taking any additional steps necessary to make the organization no worse off than it would be if the disqualified person had not taken excess benefits. Thus if a disqualified person is to receive a discretionary bonus of unknown amount, the reasonableness of his or her compensation cannot be determined — and the three procedural requirements of the presumption cannot be met — until the amount of the bonus is known. The exact application of this timing rule may be clarified in the final regulations.[76] Correction can be accomplished by repaying the organization an amount of money equal to the excess benefit, as well as any amount needed to compensate the organization for the loss of the use of the money or other property that constituted the excess benefit from the time it was paid to the time of correction.[77] Returning property that has been the subject of an excess benefit transaction will not necessarily achieve correction. For example, if a piece of real property is sold to a disqualified person at less than fair market value, and the property is then contaminated with toxic waste, returning the property to the organization will make the organization worse off than it would have been had it not conducted the excess benefit transaction.

76. I.R.C. § 4958(f)(6) (1998).
77. Prop. Treas. Reg. § 53.4958-1(c)(2)(ii), 63 Fed. Reg. 41,496 (1998).

As noted above, if an organization and disqualified person enter into a contract that provides for a series of payments over time, and one of the early payments is determined to constitute an excess benefit transaction, correction does not necessarily require termination of the contract. However, the terms of the contract may need to be modified to avoid future excess benefit transactions.[78]

Abatement of the First-Tier Tax

Under § 4962, the first-tier tax imposed on the excess benefit transaction shall be abated if it can be established to the satisfaction of the Secretary that

- the excess benefit transaction was due to reasonable cause and not to willful neglect; and
- the excess benefit transaction was corrected within sufficient time after the mailing of the notice of deficiency with respect to the second tier tax.[79]

Generally, the disqualified person is given ninety days after the mailing of the notice of deficiency to complete the correction, as well as any additional time that a suit with respect to the second-tier tax is pending in Tax Court, but the Secretary has the discretion to give as much additional time as he or she determines is reasonable and necessary.[80]

Abatement of Second-Tier Tax

Under § 4961, the second-tier tax imposed by § 4958 shall be abated if the excess benefit transaction is corrected within sufficient time after the mailing of the notice of deficiency with respect to the second tier tax. As for the abatement of the first-tier tax, generally, the disqualified person is given ninety days after the mailing of the notice of deficiency with respect to the second-tier tax to complete the correction, as well as any additional time that a suit with respect to the second-tier tax is pending in Tax Court, but the Secretary has the discretion to give as much additional time as he or she determines is reasonable and necessary.[81]

Tax Paid by Organization Managers

The statute also imposes a tax, equal to ten percent of the excess benefit, on the knowing and willful participation of any organization manager in an excess benefit transaction, unless the participation was due to reasonable cause. The organization manager must pay the tax. The tax paid by any organization manager for a single transaction is limited to $10,000. If more than one organization manager knowingly and willfully participates in the

78. *Id.*
79. I.R.C. § 4962(a) (1998).
80. I.R.C. § 4963(e) (1998).
81. I.R.C. § 4963(e) (1998).

excess benefit transaction, all such organization managers are jointly and severally liable for the organization manager tax.

Organization Managers

The statute provides that organization managers are officers, directors, and trustees of an organization, as well as any individuals having similar powers or responsibilities. The proposed regulations define an officer as including a person specifically designated as an officer under the organization's articles of incorporation or bylaws and any person who "regularly exercises general authority to make administrative or policy decisions on behalf of the organization."[82] The proposed regulations specify that independent contractors acting solely as attorneys, accountants, and investment managers are not officers.[83] Further narrowing the concept of organization managers, the proposed regulations state that anyone whose authority is limited to recommending particular administrative or policy decisions and who cannot implement those recommendations without approval of a superior, is not an officer.[84]

In addition, if an organization invokes the rebuttable presumption of reasonableness described above based on the actions of a committee, all members of the committee that approves the transaction are deemed to be organization managers, regardless of whether they are also officers, directors, or trustees.[85]

Standard for Imposing Organization Manager Tax

The tax is imposed only if the manager participates in the transaction knowingly, willfully, and without reasonable cause. The proposed regulations give the following interpretation of what it means to "participate:"

> [P]articipation includes silence or inaction on the part of an organization manager where the manager is under a duty to speak or act, as well as any affirmative action by such manager. However, an organization manager will not be considered to have participated in an excess benefit transaction where the manager has opposed such transaction in a manner consistent with the fulfillment of the manager's responsibilities to the applicable tax-exempt organization.[86]

The intermediate sanctions regulations adopt the same language.[87]

The manager's participation must also be knowing, meaning that the manager:

82. Prop. Treas. Reg. § 53.4958-3(c)(2), 63 Fed. Reg. 41,498 (1998).
83. Prop. Treas. Reg. § 53.4958-3(e)(2), 63 Fed. Reg. 41,499 (1998).
84. Prop. Treas. Reg. § 53.4958-1(d)(2)(B)(i), 63 Fed. Reg. 41,496 (1998).
85. Prop. Treas. Reg. § 53.4958-1(d)(2)(B)(ii), 63 Fed. Reg. 41,496 (1998).
86. Prop. Treas. Reg. § 53.49458-1(d)(3), 63 Fed. Reg. 41,496 (1998). Note that the language is the same as used in the private foundation rules under Treas. Reg. § 53.4941(a)-1(b)(2) (1995).
87. Prop. Treas. Reg. § 53.4958-1(d)(3), 63 Fed. Reg. 41,496 (1998).

- had actual knowledge of sufficient facts to determine that the transaction would be an excess benefit transaction;
- was aware that the act might violate the federal tax law governing excess benefit transactions; and,
- either negligently failed to make reasonable attempts to ascertain whether the transaction was an excess benefit transaction or knew that the transaction was an excess benefit transaction.[88]

The manager's participation must be willful, meaning it is "voluntary, conscious, and intentional."[89] Participation by an organization manager is not willful if the manager does not know that the transaction is an excess benefit transaction.

The manager's participation also cannot be due to reasonable cause. A manager has "reasonable cause" for participation in a transaction if he or she has exercised his or her responsibility "with ordinary business care and prudence."[90] If a manager relies on the advice of legal counsel expressed in a reasoned written opinion that a transaction is not an excess benefit transaction, the manager's participation ordinarily is not knowing or willful and is due to reasonable cause.[91] The manager must fully disclose the factual situation to legal counsel in order for this rule to apply. This advice of counsel rule applies to in-house counsel, as well as to an outside law firm. The same advice of counsel safe harbor has existed for years under the self-dealing rules of § 4941 and the taxable expenditure rules of § 4945 that apply to private foundations. The IRS and Treasury have specifically solicited comments on whether opinions of other qualified experts should have the same effect and whether the regulations under the private foundation self-dealing rules and taxable expenditure rules should be changed as well to include other types of experts. A question has also been raised about whether the safe harbor applies if legal counsel provides an opinion based on another opinion provided from a valuation expert as to the reasonableness of compensation or fair market value of property. There is no clear answer to this question at present.

Relationship Between Intermediate Sanctions and Revocation of Exempt Status

The enactment of § 4958 does not affect the standards for exemption under § 501(c)(3) or § 501(c)(4). Organizations must respect the prohibition against inurement in order to be described in those sections. Nevertheless, the preamble to the proposed regulations addresses how the relationship between intermediate sanctions and revocation of tax-exempt status will be handled as an enforcement matter. The preamble includes the following statement:

88. Prop. Treas. Reg. § 53.4958-1(d)(4), 63 Fed. Reg. 41,497 (1998).
89. Prop. Treas. Reg. § 53.4958-1(d)(5), 63 Fed. Reg. 41,497 (1998).
90. Prop. Treas. Reg. § 53.4958-1(d)(6), 63 Fed. Reg. 41,497 (1998).
91. Prop. Treas. Reg. § 53.4958-1(d)(7), 63 Fed. Reg. 41,497 (1998).

> The IRS intends to exercise its administrative discretion in enforcing the requirements of § 4958, § 501(c)(3) and § 501(c)(4) in accordance with the direction given in the legislative history. The legislative history specifically provides that the IRS may still revoke the tax-exempt status of an organization for violating the inurement proscription, with or without imposition of § 4958 excise taxes. It further provides that, in practice, the excise taxes imposed by § 4958 will 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 other tax-exempt organization. In determining whether an excess benefit transaction rises to such a level, factors relating to the organization's general pattern of compliance with the requirements of §§ 501(c)(3) or (4) and other applicable Federal and State laws will be taken into account. These factors would include whether the organization has been involved in repeated excess benefit transactions; whether, after concluding that it has been party to an excess benefit transaction, the organization has implemented safeguards to prevent future recurrences; and whether there was compliance with other applicable laws. The IRS intends to publish the factors that it will consider in exercising its administrative discretion in guidance issued in conjunction with the issuance of final regulations under § 4958.[92]

This enforcement policy is particularly important for large complex institutions like colleges and universities. Individual instances of wrongdoing may occur despite the best policies and practices. The consequences for a college or university of losing its tax-exempt status, especially if it has been a conduit borrower of tax-exempt bonds, can be devastating. The effects are felt not only by the institution, but also more importantly by its many constituencies, ranging from students to faculty to other employees to alumni to surrounding economically dependent communities. Allowing intermediate sanctions to serve as the sole penalty where an institution has acknowledged that improper actions took place and has taken steps to prevent any further abuse of its resources protects the public interest and the institution's primary constituencies. It also enables the IRS to engage in rigorous enforcement against abusive practices without impeding the accomplishment of charitable and educational purposes.

A Few Procedural Issues

Statute of Limitations

If an organization discloses an item in its annual information return (Form 990) sufficient to put the IRS on notice of the existence and nature of the item, the three-year limit on assessment and collection will run from the due date for the return. If the item is not adequately disclosed, there will be a six-year limitation on assessment and collection running from the due date for

92. Prop. Treas. Reg. § 53.4958, 63 Fed. Reg. 41,488 (1998).

the return.[93] These rules for limitations apply even though the return is filed by the organization and not by the disqualified person who would be liable for the § 4958 tax.[94]

Challenging a Section 4958 Tax in Tax Court

A disqualified person may challenge the imposition of a § 4958 tax in Tax Court.[95] The taxpayer generally has ninety days after the issuance of a notice of deficiency to file a petition in Tax Court. However, that period may be extended if the Service has granted additional time for correction.[96]

Refund Claims

The disqualified person has three years from the time the relevant return is filed paying the § 4958 tax (Form 4720) to claim a refund. Payment of the first-tier tax shall be enough for the taxpayer to bring a refund claim and maintain an action with respect to the second-tier tax as well.[97]

CONCLUSION

The proposed regulations have given a much more detailed picture of how the intermediate sanctions rules drafted by Congress will actually penalize abusive transactions. The proposed regulations have also shown more clearly how the existence of intermediate sanctions can affect the regular operations of tax-exempt organizations, especially large institutions like colleges and universities. However, as the comments that have been submitted to date show, various points are in need of further clarification or revision if the rules are to serve properly as a deterrent to abusive activity and not as a burden on responsible behavior.

Equipped with the guidance now available, colleges, universities, and other covered exempt organizations would be well advised to take several steps to minimize their exposure to intermediate sanctions. As a preliminary measure, organizations should attempt to identify all their disqualified persons. In some cases, the list may have two groups: those who are definitely disqualified persons; and those who could be under the facts and circumstances test. Even if there is some uncertainty, making the effort to identify those likely to be disqualified persons will help the institution to be appropriately cautious.

93. Treas. Reg. § 301.6501(e)-1(c)(3)(ii) (1982) (as it would be amended by the proposed intermediate sanctions regulations).

94. Treas. Reg. § 301.6501(n)-1(a) (1982) (as it would be amended by the proposed intermediate sanctions regulations).

95. I.R.C. § 6213(a) (1998). The tax imposed by § 4958 is a tax imposed under chapter 42 and, therefore, is within the scope of this section.

96. Treas. Reg. § 301.6213-1(e) (1995) (as it would be amended by the proposed intermediate sanctions regulations).

97. Treas. Reg. § 301.7422-1(b) (1995) (as it would be amended by the proposed intermediate sanctions regulations).

Institutions will also want to review their policies and procedures for entering into compensation arrangements and large property transactions to ensure the transactions are being reviewed with the appropriate level of care. Small organizations with only a few disqualified persons and infrequent transactions with them may be able to subject each of these transactions to board review and documentation. Larger organizations, such as universities or hospitals, probably will be able to give board approval to only the most significant transactions and compensation for the highest ranking officers. They will need to delegate responsibility for reviewing most transactions to other committees, subject to procedures that meet the requirements for the rebuttable presumption.

All affected organizations will need to review and regularize their recordkeeping practices. The proposed regulations place a premium on maintenance of careful records documenting board consideration — or consideration by the board's designees — of transactions between the organization and its disqualified persons. In some cases, contemporaneous records evidencing board consideration and a deliberate decision concerning a transaction may make the difference between a transaction the IRS chooses to respect and one it challenges. Records showing that payments and benefits are clearly being provided in exchange for services, including tax information returns, are also critical.

Further, organizations must regularly update and review appropriate comparability data for compensation arrangements with disqualified persons. The required thoroughness and sophistication of the data will vary. A large university or hospital likely will need access to a large sophisticated database, perhaps a proprietary one maintained by a compensation consultant and perhaps one generated cooperatively by higher education institutions. In contrast, a smaller organization paying a modest salary to its executive director may be able to rely on published information or data gathered from a few neighboring organizations.

In sum, the implementation of intermediate sanctions will force covered organizations to review the practices and procedures they follow when spending their resources. A new premium has been placed on having sound policies that help the organization protect its assets and ensure they are used wisely and exclusively in furtherance of charitable purposes.