A Selective Review of the Intermediate Sanctions Temp. Regs.—Generally, Improved All Around

By Pamela S. Kaufmann

An examination of what the Treasury has done—and failed to do—to guide exempt organizations toward compliance with the intermediate sanctions law reveals that many of the more restrictive provisions of the Proposed Regulations have been liberalized, particularly the rules regarding the operation of the rebuttable presumption of reasonableness.

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The new intermediate sanctions Temporary Regulations (TD 8920, 1/9/01), though predictable enough, offer some important insights and welcome clarifications. They even contain a few surprises. Nonetheless, this sequel to the 1998 Proposed Regulations blazes less new territory than some practitioners had hoped, and it neglects a few key issues.

HOW DID WE GET HERE?

Few tax practitioners expected that four and a half years after enactment of the intermediate sanctions law, we would still not have the benefit of final implementing Regulations to guide us and our clients. Yet this is exactly what occurred. Section 4958 was added to the Code on 7/30/96 as part of the Taxpayer Bill of Rights 2.[1] Two years later, the Treasury issued Proposed Regulations implementing the new law.[2] A public comment period culminated in two days of public hearings in early 1999.[3] The Treasury originally was expected to issue the final Regulations by the end of that year. Instead, not until the final weeks of the Clinton Administration were Temporary Regulations published, and without any guidance on one of the most sensitive subjects under the intermediate sanctions law: the treatment of revenue-sharing arrangements.

The Treasury is now entertaining written comments and requests for a public hearing. There even is some speculation that final Regulations will be issued in the next year if the Service, Treasury and Office of Chief Counsel can resolve the remaining issues, including revenue-sharing transactions, promptly.

INTERMEDIATE SANCTIONS AT A GLANCE

"Intermediate sanctions" refer to the excise taxes that may be levied against (1) certain insiders who engage in "sweetheart deals" with Section 501(c)(3) public charities and Section 501(c)(4) social welfare organizations, and (2) the officers, directors, and others who approve or condone such deals. Called "intermediate sanctions" because they represent a compromise between inaction and revocation of the organization's tax exemption, these excise taxes are designed to penalize the insider or "disqualified person" who is unjustly enriched by a transaction with an exempt organization (EO) rather than the EO that was foolish enough to engage in the transaction with the insider. This law, which had its genesis in the private foundation rules,[4] came about because the penalty of revocation often exceeded the offense and thus was seldom used.

In brief, the law states that if a transaction between an "applicable tax-exempt organization" and a "disqualified person" confers an "excess benefit" on the disqualified person, he or she is liable for an excise tax equal to 25% of the excess benefit or 200% of the excess benefit if the transaction is not "corrected" in a timely manner.[5]

Furthermore, "organization managers" who knowingly "participate" in the transaction can be held personally liable for an excise tax equal to 10% of the excess benefit, up to $10,000.[6] Under Section 4958(d)(1) liability is joint and several, and under Temp. Reg. 53.4958-1T(f) covered transactions include all those occurring after 9/13/95.

The legislative history and the 1998 Proposed Regulations contained two safe harbors that help mitigate the potentially punitive effects of the law:

1. An organization can invoke a "rebuttable presumption of reasonableness" if an "authorized body" of the organization approves the transaction in advance, relies on "appropriate data" regarding comparability, and "adequately documents" the basis for its findings.[7]

2. Similarly, "organization managers" can protect themselves from liability for the 10%/$10,000 excise tax by relying on a "reasoned written opinion" of certain professionals.[8]

Through these safe harbors, the organization and its managers (but not the disqualified person) can help insulate themselves from liability for intermediate sanctions.

The challenge of this beguilingly simple statute is to apply it properly to a given entity or transaction. "Applicable tax-exempt organization," "disqualified person," "excess benefit transaction," "appropriate data," "compensation," "adequate documentation," "correction," and "initial contract" are just a few of the terms defined in painstaking detail in the Temporary Regulations.

THE ORGANIZATION OF THE REGULATIONS

After 13 pages of commentary in the Preamble, including responses to several proposals made with respect to the 1998 Proposed Regulations, the Temporary Regulations are organized as follows:

1. Taxes on excess benefit transactions, including, inter alia, definitions of "excess benefit," "organization manager," and "participation," and rules governing joint and several liability, statutes of limitation, and effective dates (Temp. Reg. 53.4958-1T).

2. Definition of "applicable tax-exempt organization" (Temp. Reg. 53.4958-2T).

3. Definition of "disqualified person" (Temp. Reg. 53.4958-3T).

4. "Excess benefit transaction," including a definition, exclusions, and the "initial contract rule" (Temp. Reg. 53.4958-4T).

5. Rebuttable presumption of reasonableness (Temp. Reg. 53.4958-6T).

6. Correction (Temp. Reg. 53.4958-7T).

7. Special rules, including those governing church tax inquiries under Section 7611 (Temp. Reg. 53.4958-8T).

Another section has been reserved for future Regulations governing revenue-sharing arrangements.[9] The Service has touted the Temporary Regulations as an easy-to-use "road map" for avoiding inurement.[10] Whether or not this proves true, the Temporary Regulations certainly are comprehensive—albeit with a few glaring omissions.

OMISSIONS

The Temporary Regulations are perhaps most noteworthy for what they do not do. First, the Treasury has declined to provide final regulatory guidance, opting instead to promulgate Temporary Regulations (re-proposed as REG-246256-96, 1/9/01) that expire by their own terms on 1/9/04.[11] The reasons offered for this delay vary but probably boil down to a failure to reach agreement on all issues (especially revenue-sharing) among the Service, Treasury, and the Office of Chief Counsel.

Second, as noted above, the Temporary Regulations fail to provide guidance regarding the treatment of revenue-sharing transactions, instead inviting further comment on this subject before Regulations are issued. EO practitioners, particularly in the health care arena, had eagerly awaited amplification of the relatively scant revenue-sharing Proposed Regulations published in 1998. Such transactions, in which the employee or independent contractor receives compensation determined (in whole or part) by the organization's revenues,[12] are very common in the rapidly changing health care environment. They also appear frequently in compensation arrangements with fundraisers and development directors. The Proposed Regulations caused great concern because they suggested that revenue-sharing arrangements might constitute excess benefit transactions, even if the *total* compensation paid to the disqualified person was reasonable, if the benefits were not "proportional" to the services provided.[13] This provision baffled many EO advisors, as it was analytically inconsistent with prior pronouncements regarding private inurement[14]

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[1] See Mancino, "New 'Intermediate Sanctions' May Cause Public Charities to Change the Way They Do Business," 85 JTAX 369 (December 1996).

[2] REG-246256-96, 63 Fed. Reg. 41486 (8/4/98). See Broccolo *et al.*, "Rules to Live By: IRS Releases Intermediate Sanctions Regulations," 21 Exempt Org. Tax Rev. 287 (September 1998).

[3] Treasury and IRS conducted public hearings in Maryland on 3/16-17/99. Twenty-two witnesses testified, including several who were connected by video link from Los Angeles.

[4] Section 4940 *et seq.*

[5] Sections 4958(a)(1) and (b).

[6] Sections 4958(a)(2) and (d)(2).

[7] H. Rep't No. 104-506, 104th Congress, 2d Sess. (1996), 53, 56-7; Prop. Reg. 53.4958-6.

[8] Prop. Reg. 53.4958-1(d)(7).

[9] Temp. Reg. 53.4958-5T.

[10] See comments of Steven J. Miller, Director of the Service's Exempt Organization Division, in "Easier Compliance is Goal of New Intermediate Sanctions Regulations," published on Bay Area Community Foundations website, 1/22/01.

[11] Temp. Reg. 53.4958-8T(c). Sections 7805(e)(1) and (2) require that Temporary Regulations be issued also as Proposed Regulations and expire at the end of three years.

[12] Section 4958(c)(2). The transaction must result in inurement to be deemed an "excess benefit transaction."

[13] See Prop. Reg. 53.4958-5(a).

[14] See, e.g., Rev. Rul. 69-383, 1969-2 CB 113; GCM 39498, 4/24/86; GCM 39670, 10/14/87; and GCM 39674, 10/23/87. See also *IRS Audit Guidelines for Hospitals,* IRS Manual Transmittal 7(10)69-38, sections 333.2 and 333.3 (3/27/92) for a review of private inurement and private benefit issues peculiar to hospitals. The inurement analysis of hospitals' relationships with physicians is clearly evolving. For example, GCM 39862, 11/21/91, contained a blanket rule that all physicians on a charitable hospital's medical staff were per se insiders. The intermediate sanctions Temporary Regulations apparently have rejected this sweeping rule; see Temp. Reg. 53.4958-3T.

and arguably enlarged the universe of prohibited transactions with insiders. In fact, several practitioners argued that the general intermediate sanctions rules already addressed these transactions adequately and no special standard was warranted.

Until the Treasury issues Regulations that address revenue-sharing transactions, these transactions are to be evaluated employing the same criteria that apply to any other transaction between a disqualified person and an applicable EO.[15] (Any such Regulations will first be issued in temporary form.[16]) Given the more punitive approach reflected in the Proposed Regulations, this interim rule is a welcome reprieve for many EOs.

The Temp. Regs. lack guidance on one of the most sensitive subjects under the intermediate sanctions law: revenue-sharing arrangements.

The third "omission" was a determination by Treasury to defer any decision on issuing separate rules governing donor-advised funds.[17] A donor-advised fund is a segregated fund within a charity that permits the donor or others to give advice regarding (but not to direct) expenditures of the fund.[18] Although donors cannot prescribe the use of the EO's funds,[19] there is a perception that they exert great influence over this decision because a charity will not wish to jeopardize future contributions by ignoring their wishes. The Service and Treasury are sensitive to this dynamic and are concerned about the donor's opportunity to dictate the timing, amount, and recipients of such funds. For the time being, they have rejected a per se rule stating that such donors are automatically disqualified persons. Nevertheless, they have invited public comments regarding "potential issues" raised by applying an FMV standard to distributions from a donor-advised fund to (or for the use of) the donor or advisor.[20] The language of this "invitation" reveals the nature of their concerns.

WORDS OF COMFORT

Notwithstanding the omissions mentioned above, the Temporary Regulations clarify and improve on the 1998 proposals in several key respects. EO advisors should gain solace from the following clarifications.

Applicable Tax-Exempt Organization

There was at least some uncertainty under the Proposed Regulations as to which organizations would be deemed "applicable tax-exempt organizations" subject to intermediate sanctions. Much of the confusion arose from the phraseology of Section 4958(e)(1), which states that the law applies to organizations that "would be" described in Section 501(c)(3) or 501(c)(4). What if an organization engaged in charitable activities but never sought formal recognition (by filing Form 1023) as a Section 501(c)(3) charity? What if it was a church exempt under Section 508 from applying for such recognition? What about an organization that would have qualified as a social welfare organization, and held itself out as one, yet never filed a Form 1024 with the Service? What rules applied to a Section 115 governmental entity that had previously secured Section 501(c)(3) status in order to access certain benefits (such as participation in Section 403(b) retirement plans)? When, if ever, were foreign organizations subject to intermediate sanctions? And what was the status of an EO that converted to a taxable entity or had its exemption revoked? The Temporary Regulations clarify all these matters:

- A Section 501(c)(3) organization must either file Form 1023 or be exempt from such filing (e.g., by being a church) to be deemed an "applicable tax-exempt organization" (Temp. Reg. 53.4958-2T(a)(2)).
- An organization will be deemed a Section 501(c)(4) social welfare organization or civic league if *either* (1) it has applied for and received recognition of exemption under Section 501(c)(4) or (2) it has sought to take advantage of Section 501(c)(4) status by filing a Form 1024 with IRS, filing an informational return (Form 990) as a Section 501(c)(4) organization, or otherwise holding itself out as a Section 501(c)(4) organization (Temp. Reg. 53.4958-2T(a)(3)).
- Governmental entities exempt from income taxation under Section 115 are not subject to the intermediate sanctions law, even if they also qualify under Section 501(c)(3) (Temp. Reg. 53.4958-2T(a)(1)). Apparently, Treasury made a policy decision not to distinguish among governmental entities for purposes of this statute. It also likely concluded that such entities presented no significant risk of abuse of the private inurement prohibition, given sunshine laws, prohibitions against "gifts of public funds,"[21] and other accountability measures. Such laws address essentially the same conduct as do the private inurement and private benefit prohibitions.
- The Temporary Regulations (like the Proposed Regulations) state that a foreign organization that receives "substantially all of its support from sources outside of the United States" is not an applicable tax-exempt organization for purposes of Section 4958 (Temp. Reg. 53.4958-2T(b)(2)).
- The intermediate sanctions apply to organizations that were described under Section 501(c)(3) or 501(c)(4) at any time beginning five years before the excess benefit transaction occurred (Temp. Reg. 53.4958-2T(a)(1)). Thus, an organization that seeks to evade intermediate sanctions by converting to taxable status still may be subject to such sanctions for as long as five years after the conversion. Under Temp. Reg. 53.4958-2T(b)(1), however, the "look-back" period begins on 9/14/95, the statute's effective

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15 See the Preamble to TD 8920, 1/9/01.

16 *Id.*

17 *Id.*

18 See Regs. 1.170A-9(e)(10) through (14) and 1.507-2(a)(8).

19 *Id.*

20 *Id.*

21 See, e.g., California Constitution, Article XVI, section 6.

date, for transactions that occurred before 9/14/00, and it ends on the date of the transaction.

- An organization will not be deemed an applicable tax-exempt organization once there has been a final determination or adjudication that it is not exempt, subject to a caveat: This rule does not apply if the determination or adjudication was caused by private inurement or one or more excess benefit transactions, subject to the five-year look-back rule described above (Temp. Reg. 53.4958-2T(a)(4)).

Disqualified Persons

This term is the linchpin of any intermediate sanctions analysis, because a transaction can be subject to excise taxes only if it was engaged in by a "disqualified person." Section 4958(f)(1)(A) defines the term as "any person who was, at any time during the 5-year period ending on the date of [the] transaction, in a position to exercise substantial influence over the affairs of the organization." The Proposed Regulations divided the universe of potentially disqualified persons into four categories: (1) "statutory" (i.e., automatically) disqualified persons, (2) persons deemed to exercise substantial influence over the organization, (3) persons deemed not to have such influence, and (4) facts and circumstances that would govern in all other cases.[22]

Although the Temporary Regulations resemble the Proposed Regulations in many respects, they are, in at least two instances, more reasonable and realistic. Mere managerial authority (without regard to the scope or extent of the authority) is no longer an indicium of substantial influence.[23] Neither is mere authority to sign bank drafts or authorize electronic funds transfers. Instead, a person is presumed to exercise substantial influence over an organization only if he or she shares authority to control or determine a "substantial" portion of the organization's capital expenditures, operating budget, or employee compensation, or manages a discrete segment or activity that itself represents a "substantial portion" of the organization's activities, assets, income, or expenses.[24] The emphasis is on substantiality; authority over a department or division that itself represents an insignificant portion of the organization's activities, budget, or assets will not ordinarily lead to a finding of substantial influence.

Through two safe harbors, the organization and its managers (but not the disqualified person) can help insulate themselves from liability.

Similarly, being a "key advisor" to a manager no longer supports a finding of substantial influence over an exempt organization.[25] This is a welcome improvement, as this category arguably would have implicated the organization's lawyers, accountants, architects, investment advisors, and other consultants.

The new definition of disqualified persons also emphasizes practical authority and deemphasizes title. Although presidents, chief executive officers, chief operating officers, treasurers, and chief financial officers are ordinarily presumed to have substantial influence over an organization,[26] it is possible to rebut this presumption by showing that despite their title, they lack ultimate responsibility for the organization's management, administration, or operation (CEOs or COOs) or its finances and budget (CFOs). Conversely, a person who has such responsibilities will be presumed to have substantial influence over the organization *regardless of title*.[27]

These most recent clarifications clearly elevate substance over form.

Intermediaries and Indirect Excess Benefits

Section 4958(c)(1)(A) defines an excess benefit transaction as "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 ... received for providing such benefit" (emphasis added). The reference to direct or indirect benefits is an attempt to close an inviting loophole: EOs might be tempted to evade the law by paying various forms of compensation to disqualified persons through third parties. While the Proposed Regulations specifically mentioned payments through entities "controlled by or affiliated with" the EO,[28] Temp. Reg. 53.4958-4T(a)(2)(iii) helps seal this loophole by also including benefits paid through an "intermediary." A benefit is furnished through an intermediary if three conditions apply:

1. The EO provides an economic benefit to a third party, i.e., the intermediary.
2. The intermediary provides economic benefits to someone who is regarded as a disqualified person with respect to the EO.
3. Either (a) there is evidence of an oral or written agreement or understanding that the intermediary will provide economic benefits to or for the use of a disqualified person, or (b) the intermediary provides such benefits without a significant business or exempt purpose for doing so.

In such event, all benefits conferred on the disqualified person, whether through the EO, its subsidiary, or an intermediary, will be considered *in toto* in the determination of whether they are excessive.[29]

The Initial Contract Rule

Several practitioners commented on the inherent unfairness of the Proposed Regulations in failing to afford "one free bite" of the apple to people and entities who were not disqualified persons immediately *before* entering into a transaction with an EO but who were deemed qualified persons *by*

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22 Prop. Regs. 53.4958-3(b) through (e).

23 Temp. Regs. 53.4958-3T(e)(2)(iv) and (v); see also the Preamble to TD 8920.

24 *Id.*

25 See the Preamble to TD 8920.

26 Temp. Regs. 53.4958-3T(c)(2) and (3).

27 *Id.*

28 Prop. Reg. 53.4958-4(a)(2).

29 Temp. Reg. 53.4958-4T(a)(1). Four examples in Temp. Reg. 53.4958-4T(a)(2)(iv) illustrate the application of the new intermediary provision.

virtue of the transaction.[30] Temp. Reg. 53.4958-4T(a)(3) provides significant relief by introducing an "initial contract rule" that protects certain payments made under a binding written contract with such persons. Payments covered by this rule are not deemed excess benefit transactions, even if the person's duties under the contract would make him or her a disqualified person prospectively.

The Prop. Regs. suggested that revenue-sharing arrangements might be excess benefit transactions even if the total paid was reasonable.

To be eligible for this exception, the payments must be "fixed." This means that either the amounts must be specified in the contract or they must be determined by using a "fixed formula" based on preestablished, objective criteria. If the formula permits the exercise of *any* person's discretion, including the board's, the payment is not fixed and the initial contract exception is not available.[31] In addition, this rule does not protect payments made under the contract once it is materially modified or the person who was entitled to receive payments fails substantially to perform his or her contractual obligations.[32] The applicability of this exception is amply illustrated in eleven examples, in Temp. Reg. 53.4958-4T(a)(3)(vii). In the event a contract includes both fixed and non-fixed payments, the two types of payments are analyzed separately.[33]

The initial contract rule represents the Service's acknowledgment, if not total acceptance, of the decision in *United Cancer Council, Inc.*, 165 F.3d 1173, 83 AFTR2d 99-812 (CA-7, 1999). In that case, the Seventh Circuit held that an independent contractor who provided fundraising services to the United Cancer Council was not an insider with regard to the charity, and thus was not subject to the private inurement prohibition, even where the contract was extremely favorable to the fundraiser.[34] In so ruling, the appellate court rejected the Tax Court's earlier holding (109 TC 326 (1997)) that the fundraiser was an insider, notwithstanding the absence of a prior relationship, because it exercised control over the charity's primary funding source. The Tax Court had stated that "[w]e are not aware of any single 'one-free-bite' principle in this part of the law."

The one-free-bite rule is an important addition to the Temporary Regulations because the private foundation rules include such a rule. Practitioners have believed that the self-dealing rules applicable to public charities and Section 501(c)(4) organizations should be at least as favorable as those that apply to private foundations.

After the Seventh Circuit's decision, EO practitioners wondered whether the Treasury might change the definition of disqualified persons to exempt individuals and entities who had no relationship with the organization before the transaction at issue. The Temporary Regulations did not adopt this broad exemption, but instead implemented the somewhat narrower one-free-bite rule. While this proposed rule represents something less than complete acquiescence in the Seventh Circuit's decision, it is a welcome (albeit carefully circumscribed) liberalization of the excess benefit transaction rules.

Timing, Series of Transactions, and Deferred Compensation

When exactly does an excess benefit transaction occur? Ordinarily, this event occurs on the date that the disqualified person "receives" the benefit.[35] But what date is used if payments are made in installments or the benefits do not immediately vest? The Temporary Regulations address both scenarios.

If a transaction involves a series of payments, Temp. Reg. 53.4958-1T(e)(1) deems the transaction to occur on the last date of the tax year (or, if the payments extend beyond one year, on the date of the last payment in the series). Furthermore, Temp. Reg. 53.4958-1T(e)(2) provides that benefits paid pursuant to a qualified pension, profit sharing, or stock bonus plan are not deemed a "transaction" under the intermediate sanctions law until the forfeiture risk lapses (that is, until the deferred compensation benefits vest).[36] Notwithstanding this fact, employers can qualify deferred compensation packages under the rebuttable presumption of reasonableness (described below) as soon as the amount paid under the package or the formula for calculating such amount becomes "fixed."[37]

Disregarded Benefits

Perhaps one of the most controversial provisions in the Proposed Regulations was the one governing "disregarded economic benefits" (that is, benefits that are not considered in determining whether an excess benefit transaction occurred). One hotly disputed provision stated that board members' travel to board meetings would be disregarded for purposes of the intermediate sanction rules, but expressly excluded "luxury travel" and "spousal travel."[38] This provision was criticized for several reasons. For example, why was travel for other purposes (e.g., site visits and educational seminars) or by non-board members (e.g., executive staff) excluded? What was meant by "luxury travel?" Why was spousal travel flatly excluded? At least in certain circumstances, one could argue that attendance by spouses and significant others at EO events promotes an organization's exempt purposes.

Perhaps perceiving the wisdom of these criticisms, and perhaps for administrative ease, the Treasury has re-

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30 See the Preamble to TD 8920.

31 Temp. Reg. 53.4958-4T(a)(3)(ii).

32 Temp. Regs. 53.4958-4T(a)(3)(iv) and (v).

33 Temp. Reg. 53.4958-4T(a)(3)(vi).

34 The fundraiser reportedly used approximately 90% of the funds raised to defray the costs of the fundraising campaign! See Hill, "Deregulating the Exempt Sector? CA-7 Reverses Tax Court in *United Cancer Council*," 90 JTAX 303 (May 1999).

35 Temp. Reg. 53.4958-1T(e)(1).

36 Where the disqualified person elects to include an amount in gross income in the tax year of transfer, pursuant to Section 83(b), the general rule of receipt noted in the text, above, applies to property included in the Section 83(b) election.

37 See Temp. Reg. 53.4958-6T(d).

38 Prop. Reg. 53.4958-4(a)(3)(i).

placed the original proposal with a somewhat more elegant standard in Temp. Reg. 53.4958-4T(a)(4)(i): All nontaxable fringe benefits under Section 132 are now disregarded for intermediate sanctions purposes. Thus, employer-provided health benefits, qualified employee discounts, benefits through educational and adoption assistance programs, transit passes, qualified parking, and other benefits need not be considered in determining what constitutes an excess benefit transaction with a disqualified person.[39] One notable exception to this rule, however, is liability insurance—certain liability insurance payments must be analyzed under the excess benefit transaction rules, notwithstanding their general exclusion from income under Section 132.[40]

The insurance and indemnification dilemma. The Proposed Regulations' treatment of insurance premiums and indemnification engendered no small amount of confusion and controversy. Perhaps due to inartful drafting, the Proposed Regulations arguably implied that liability insurance benefits provided to board members needed to be reported by the directors as taxable income to avoid being deemed excess benefits to them. This unfortunate interpretation was the by-product of two different provisions. One stated that liability insurance premiums paid on behalf of disqualified persons for intermediate sanctions liability would *not* be deemed excess benefits *if* they were treated as compensation.[41] The other seemed to require the organization to manifest its intent to treat an item as compensation by reporting it on a Form W-2, 1099, or 990, or by having the disqualified person treat it as such on his or her Form 1040.[42]

The Temporary Regulations have eliminated this confusion by making several clarifications. First, under Temp. Reg. 53.4958-4T(b)(1)(ii)(B)(*2*), such premiums will be deemed compensation *only* to the extent that they pay for intermediate sanctions penalties, extraordinary employment-related litigation expenses, or expenses resulting from the director's willful, unreasonable acts or omissions, and then only to the extent that they are *not* deemed de minimis fringes under Section 132(a)(4). This distinction is derived directly from the private foundation rules governing directors' and officers' liability insurance.[43] Second, Temp. Reg. 53.4958-4T(b)(1)(C) expressly states that the treatment of an item as compensation for intermediate sanctions purposes has absolutely no bearing on whether an item is deemed compensation for income tax purposes.

An EO that converts to taxable status still may be subject to intermediate sanctions for as long as five years after the conversion.

These clarifications, while helpful, may create additional legal and practical challenges. For example, will EOs be able to allocate insurance premiums between compensation and disregarded benefits? Will insurance companies provide this information to their insureds? Furthermore, state insurance laws may prohibit the provision of insurance to pay fines or penalties.[44] Will insurance coverage even be available in these states to cover intermediate sanctions penalties? The experience of private foundations under Section 4941 may shed light on these issues.

To avoid the risk of triggering a tax event for volunteer directors, it is advisable not to issue a Form W-2 or 1099 to directors or to suggest that they report liability insurance as income on their Form 1040. Where such insurance is not disregarded under Section 132, a board resolution, memorandum, agreement, or similar form of documentation should address the "manifestation of intent" requirement of the Temporary Regulations without triggering an unintended tax liability.

Rebuttable Presumption of Reasonableness

The rebuttable presumption of reasonableness in Temp. Reg. 53.4958-6T may be the single greatest beneficiary of the Treasury's recent largesse—virtually every element of this presumption has been liberalized.

Approval by an authorized body. Although compensation of a disqualified person must be approved by an "authorized body" of the organization composed entirely of individuals who do not have a conflict of interest,[45] this standard has been relaxed in two respects:

1. The standard will be met where a disqualified person recuses him- or herself from the body's deliberations and decision. That is, the body is not tainted by his or her mere appointment or election to it.[46]

2. The governing body may now delegate compensation decisions to other parties authorized by state law to act on its behalf in accordance with board-prescribed procedures for approving compensation arrangements or property transfers.[47]

Despite this second clarification, the "authorized body" must still have the authority of the board under state law if it is to approve the compensation. For example, under California law, only board committees expressly delegated the authority of the full board and consisting *exclusively* of directors have the authority to bind the board.[48] Authority to act subject to board ratification is insufficient to invoke the presumption. Thus, as a practical matter, depending on the state's corporations law, the right to delegate may be somewhat illusory. In states that do not confer the authority of the board on any other body, it will be virtually impossible to protect transactions affecting the entire board (e.g.,

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39 See Sections 132 and 162. By referring to Section 132, the Temporary Regulations adopt existing standards of reasonableness under Section 162. See the Preamble to TD 8920.

40 Temp. Regs. 53.4958-4T(a)(4)(i) and (b)(1)(ii)(B)(*2*).

41 Prop. Reg. 53.4958-4(a)(4).

42 Prop. Reg. 53.4958-4(c)(2)(ii).

43 Reg. 53.4941(d)-2(f)(3).

44 See, e.g., Cal. Ins. Code section 533.5.

45 Temp. Reg. 53.4958-6T(c)(1).

46 Temp. Reg. 53.4958-6T(c)(1)(ii).

47 Temp. Reg. 53.4958-6T(c)(1)(i)(C).

48 Cal. Corp. Code section 5212.

reimbursement of expenses to attend trade association meetings).

The Temporary Regulations, like the Proposed Regulations, prohibit the use of "reciprocal approval" arrangements to evade the presumption's disinterested body requirement. That is, two (or more) directors, each of whom is financially interested in a transaction being considered for approval, will be deemed to have a conflict of interest if they approve each other's compensation.[49] On this point, the Temporary Regulations are arguably too onerous. First, they do not require any explicit or implicit "agreement" of reciprocal approval; the mere fact that such approvals flow in both directions is sufficient to create a conflict of interest. Second, they state that there is a conflict of interest if one director "has approved or will approve" a transaction providing benefits to the other.[50] How much time must elapse between approvals for there to be no inference that there was a *quid pro quo* between the directors?

Appropriate data. The Temporary Regulations also relax the definition of "appropriate data" for determining the comparability of compensation. In contrast to the Proposed Regulations, Temp. Reg. 53.4958-6T(c)(2)(i) permits such data to be developed internally within the organization.[51] That is, they need not be secured, often at great expense, from an independent consultant. In addition, the list of acceptable data has been expanded. Appropriate data include, without limitation, the following:

- Compensation paid by similar organizations (whether taxable or exempt) for "functionally comparable positions."
- A description of whether similar services are available in the organization's geographic area.
- *Current* compensation surveys compiled by independent firms.
- Actual written offers from similar institutions competing for the disqualified person's services.
- *Current* independent appraisals of the value of any property transferred.
- Offers received as part of an open and cooperative bidding process.

The Temporary Regulations also suggest that a national survey may be appropriate where it categorizes compensation data based on various factors. In one example, a compensation survey for a university president's position that does *not* categorize data by number of students served, annual revenues, academic ranking, or geographic location is *not* deemed appropriate.[52] In contrast, a national survey is appropriate where data are categorized by the size of the institution (based on students served and revenues) and geographic locale.[53]

Excise taxes apply only if a transaction was engaged in by a 'disqualified person,' the linchpin of any intermediate sanctions analysis.

Furthermore, the Temporary Regulations clarify that somewhat older data may be comparable if the authorized body has no information indicating that relevant market conditions have changed or that the results of the survey are no longer valid.[54] In that example, however, the results are only one year old. This begs the question as to whether a two- or three-year-old survey may, in certain circumstances, be valid. Also note the Treasury's repeated emphasis on the *currency* of data used. Some might argue that compensation surveys are outdated as soon as the results are compiled and published.

Small organizations safe harbor. The safe harbor for small organizations (i.e., EOs whose annual gross receipts are less than $1 million) is also easier to satisfy under the Temporary Regulations. The board or committee will be deemed to have obtained "appropriate data" if it gathers compensation data from three comparable organizations in the same or similar community for the same or similar services.[55] The Proposed Regulations required data from *five* organizations.[56]

Adequate documentation. Finally, documentation of the reasonableness of the transaction no longer needs to be prepared by the next meeting of the governing board or committee. It may now be prepared either by the next meeting or up to 60 days after the final action or actions of the authorized body.[57] This is a welcome change, as board meetings often follow such reasonableness determinations by a matter of days (or hours).

To state the obvious, an organization's failure to meet the requirements of the rebuttable presumption of reasonableness creates absolutely no inference that the transaction was an excess benefit transaction. Nonetheless, many organizations, as part of their corporate compliance or risk management programs, regularly invoke this protection to help contain their losses. Unfortunately, such presumption cannot be invoked for groups or classes of employees, thus necessitating a person-by-person compensation analysis.[58] This is an unfortunate feature of the Temporary Regulations that should be corrected in the final version.

Organization Managers

To assure that EOs paid attention to the private inurement prohibition, Congress imposed excise taxes on not only the "unjustly enriched" disqualified persons but also the "organization managers" who allowed this unjust enrichment to occur. As noted above, organization managers can be compelled to pay 10% of the excess benefit, up to $10,000, for any one excess benefit transaction.[59] Furthermore, because the liability is joint and several,[60] a board member with a deep pocket could ultimately be held responsible for the entire excise tax.

Temp. Reg. 53.4958-1T(d)(2) does not

NOTES

49 Temp. Reg. 53.4958-6T(c)(1)(iii)(E).
50 *Id.*
51 See also the Preamble to TD 8920.
52 Temp. Reg. 53.4958-6T(c)(2)(iv), Example 1.
53 *Id.*, Example 2.
54 *Id.*, Example 4.
55 Temp. Reg. 53.4958-6T(c)(2)(iii).
56 Prop. Reg. 53.4958-6(d)(2)(ii).
57 Temp. Reg. 53.4958-6T(c)(3)(ii).
58 See the Preamble to TD 8920.
59 Sections 4958(a)(2) and (d)(2).
60 Section 4958(d)(1).