EXEMPT ORGANIZATIONS BULLETIN

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Treasury Regulations Implement "Intermediate Sanctions"

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The Treasury Department has issued long-awaited guidance, in the form of temporary regulations, under section 4958 of the Internal Revenue Code of 1986, as amended (the "Code"). Known as the "intermediate sanctions" provision, section 4958 was enacted by section 1311 of the Taxpayer Bill of Rights 2, P.L. 104-168, and is generally effective for transactions occurring on or after September 14, 1995.

Section 4958 imposes penalty taxes on transactions between certain taxexempt organizations and related persons. Covered organizations include universities, hospitals, museums, and any other "public charities" described in section 501(c)(3) of the Code, as well as certain organizations described in section 501(c)(4) of the Code. The temporary regulations are effective from January 10, 2001, though January 9, 2004.

Managers and "Disqualified Persons" May Be Personally Liable

A transaction is subject to scrutiny under section 4958 if it is between (1) an organization that is, or was at any time during the previous five years, exempt from federal income tax under section 501(c)(3) (other than a private foundation) or section 501(c)(4) of the Code, and (2) a so-called "disqualified person," including current and former insiders and related persons. In general, penalty taxes are imposed if the disqualified person receives an "excess benefit" as a result of the transaction.

Two separate penalty taxes may apply. The first is imposed on the disqualified person at the rate of 25 percent of any excess benefit received. To the extent the transaction is not corrected within applicable time limits, an additional tax is imposed at the rate of 200 percent of the uncorrected excess benefit. The second tax, imposed on managers of the organization who knowingly participate in the transaction, is 10 percent of any excess benefit, limited to $10,000 per transaction. A manager will not be liable if his or her participation was not willful and there was reasonable cause.

The Internal Revenue Service may impose these taxes in addition to, or in lieu of, revoking the organization's tax-exempt status.

The Regulations Help Identify "Disqualified Persons"

The temporary regulations broadly define "disqualified person." Any person in a position to exert "substantial influence" over an organization's affairs at any time during the five-year period ending on the date of the relevant transaction is considered a disqualified person. In addition, certain family members of a disqualified person, and certain entities controlled by a disqualified person, are themselves considered disqualified persons.

The temporary regulations consider the following persons to be in a position to exert substantial influence:

- voting members of the organization's governing body,
- officers who are responsible for implementing the decisions of the governing body with broad supervisory authority,
- officers for managing the organization's finances and
- in the case of a hospital that participates in a provider-sponsored organization, persons with a material financial interest in the organization.

The temporary regulations also provide that certain persons are considered not to have substantial influence. In the case of a related person who is on neither list, it is necessary to consider all relevant facts and circumstances in determining whether or not the person has substantial influence. In this regard, the temporary regulations consider, among other things, whether the person founded or contributes to the organization or exercises control over an important segment of the organization.

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Virtually any Transaction May Result in an Excess Benefit

Under the temporary regulations, a transaction gives rise to an excess benefit to the extent that the value of the benefit conferred upon the disqualified person, directly or indirectly, exceeds the value of any consideration provided in return. All forms of economic benefit must be scrutinized, including any benefit conferred as compensation or in the context of a sale and purchase of property.

Compensation results in an excess benefit if it is unreasonable. The temporary regulations consider the following items in determining whether a disqualified person's total compensation is reasonable:

- all cash and noncash compensation, including salary, fees, bonuses, severance payments, and deferred and noncash compensation under a qualified pension, profit-sharing, or stock bonus plan,
- the payment of certain liability insurance premiums and
- any other benefits, including medical, dental, life insurance and disability benefits, certain expense allowances or reimbursements and foregone interest.

In general, a payment purporting to be compensation for services rendered will not be respected as such—and will therefore risk treatment as an excess benefit—unless the organization clearly indicates its intent to treat the payment as compensation at the time it is paid.

The temporary regulations provide an exception for certain contracts that a person may enter into before becoming a disqualified person, but that provide for fixed payments thereafter. Certain economic benefits are disregarded altogether.

Safe Harbors May Limit Exposure

There are two safe harbors under which a covered organization may minimize exposure to the penalty taxes. The first provides that if the organization's governing body complies with certain procedures, it will enjoy a rebuttable presumption that the transaction is fair, and therefore not an excess benefit transaction. To invoke this safe harbor, the organization must take certain steps to ensure the fairness of the transaction and contemporaneously document compliance with the requirements of the safe harbor. The second safe harbor allows an organization's managers to avoid the 10 percent penalty tax by showing reliance on a reasoned, written opinion of an appropriate professional after full disclosure of the relevant facts. Each safe harbor provides detailed procedural requirements.

Managers Should Implement Safeguards to Avoid Penalties

To minimize the risk of section 4958 taxes, covered organizations should identify potential disqualified persons and, to the extent possible, make sure that their transactions satisfy the requirements of the safe harbors. They should also ensure that all compensation arrangements comply with the contemporaneous documentation requirements.

Available Materials

The following Treasury Decisions contain the text of and corrections to the temporary regulations, as well as background and explanatory material:

- T.D. 8920, Excise Tax on Excess Benefit Transactions, 66 Fed.Reg. 2144 (Jan. 10, 2001) [232K],
- Corrections to T.D. 8920, 66 Fed.Reg. 13013 (Mar. 2, 2001) [39K].

Tax-Exempt Organizations Subject to Increased Disclosure Requirements

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New Disclosure Burdens Imposed

Under a change in law effective in 1999, most tax-exempt organizations (other than private foundations) generally are required to provide to any individual who requests them copies of their exemption applications and annual returns filed with the Internal Revenue Service (the "IRS"). Taxpayer Bill of Rights 2, P.L. 104-168. Effective March 13, 2000, this requirement has been extended to private foundations and the period of time that private foundations must retain annual returns for public inspection has been increased. Tax and Trade Relief Extension Act of 1998, P.L. 105-277.

Prior Law Required Mostly Passive Compliance

Under prior law, most tax-exempt organizations were required to make their exemption applications available for public inspection during normal business hours at their principal offices and certain regional and local offices if (1) the application had been filed on or after July 15, 1987 (or prior thereto if the organization had in its possession a copy of the application on that date), and (2) the IRS had issued a favorable determination letter. Thus, an organization that either had not yet received a determination or had received an adverse determination was not required to disclose its exemption application. Similarly, an organization that had filed an exemption application prior to July 15, 1987 generally was not required to make its application available. In addition, private foundations were required to make annual returns available for public inspection for 180 days from the date of publication of availability, and most other tax-exempt organizations were required to make such returns available for three years from the later of the date the returns were due to be filed and the date the forms were actually filed.

Organizations Generally Must Provide Documents on Request

As a result of the recent changes in law, most tax-exempt organizations generally are required to provide to any individual who requests them copies of their exemption applications or annual returns for as long as such forms must be made available for public inspection under existing law. Copies must be provided immediately if the request is made in person or within 30 days if in writing. The organization may charge a fee to defray the costs of postage and, subject to certain limitations, photocopying documents.

Organizations May Instead Post Documents on the Internet

Under a significant exception to these requirements, an organization need not comply with a request for copies of documents that are "widely available." Treasury regulations provide that a document is considered widely available if it is posted on a Web site that complies with applicable IRS guidelines.

An organization may satisfy this exception either by posting its exemption application and annual returns on its own qualifying Web site or by relying on the fact that a second qualified organization has posted the organization's documents on its own Web site.

If an organization's documents appear on a qualifying Web site, the organization must respond to requests for copies by providing the address of the site where the documents may be downloaded. The address must be provided immediately if the request is made in person or within seven days if in writing. Even if an organization makes its exemption application and annual returns widely available, however, the documents must remain available for public inspection during normal business hours at the organization's principal office and certain regional and local offices.

Organizations Subject to Harassment Need Not Respond to Document Requests

Under the new rules, if the IRS determines that the requests that an organization has received for documents constitute a campaign of harassment and that compliance with the requests would not be in the public interest, the organization need not comply with any request that it reasonably believes is part of that campaign.

In addition, Treasury regulations provide that, even without an IRS determination of harassment, an organization may disregard the third (and any subsequent) request within a 30-day period for all or part of a particular document and the fifth (and any subsequent) request within any one-year period from the same individual or address.

Private Foundations' Annual Returns Must Be Available for Three Years

The new rules require private foundations to retain, make available for public inspection, and provide copies of, their annual returns for three years from the later of the filing due date, including extensions, and the actual date of filing. Private foundations are subject to the same requirements that apply to most other tax-exempt organizations for retaining and making available for public inspection their annual returns. However, private foundations are not required to publish the availability of their annual returns due to be filed on or after March 13, 2000.

Managers Should Actively Monitor Disclosure

These changes in law may result in an increase in the number of requests for exemption applications and annual returns. As a result, organization managers should become increasingly sensitive to the information disclosed on their applications and returns. Through an organization's exemption applications and annual returns, the public can obtain not only the organization's certificate of incorporation and by-laws, but also information relating to its relationships with other organizations, the names of its managers and information concerning their compensation, detailed information relating to the organization's finances and activities and, in the case of private foundations, the names and addresses of certain contributors.

Organization managers should also consider making the organization's documents available on the Internet. Relevant factors include (1) the cost of complying with requests for copies as compared to the cost of Internet posting, (2) the relative convenience of each method, (3) the relative ability of the organization to ascertain and track the identity of individuals requesting documents, and (4) the size and composition of the targeted audience. While some organizations may view Internet disclosure as a way to attract public support, others may consider it an additional source of unwanted public scrutiny.

Available Materials

The following Treasury Decisions contain implementing regulations as well as background and explanatory material:

- T.D. 8818, Public Disclosure of Material Relating to Tax-Exempt Organizations, 64 Fed.Reg. 17279 (Apr. 9, 1999) [60K],
- T.D. 8861, Private Foundation Disclosure Rules, 65 Fed.Reg. 2030 (Jan. 13, 2000) [135K].