

PRACTICAL PROCEDURES FOR TAX-EXEMPT HEALTH CARE ENTITIES TO AVOID "INTERMEDIATE SANCTIONS" RELATED TO EXCESS BENEFIT TRANSACTIONS

Robert F. Reilly and Ashley L. Reilly

Tax-exempt health care entities are prohibited from entering into excess benefit transactions with disqualified individuals. Such excess benefit transactions include (1) payment of employee compensation in excess of reasonable amounts and (2) payment in excess of fair market value for goods and services. In response to such excess benefit transactions, the Service can impose the Section 4958 intermediate sanctions excise tax on the disqualified individual and on the tax-exempt entity managers. This discussion recommends practical procedures the tax-exempt entity can use to avoid the imposition of these "intermediate sanctions."

INTRODUCTION

Officers, directors, trustees, and other persons "exercising influence" over a tax-exempt health care organization (TEHCO) are prohibited from receiving an "excess benefit" from the TEHCO.

If the Internal Revenue Service (the "Service") determines that such a person has received an excess benefit from a TEHCO, then a substantial excise tax can be imposed under Internal Revenue Code Section 4958. The regulations related to Section 4958 provide detailed guidance related to the imposition of those sanctions.

Section 4958 does not apply to a TEHCO that is:

1. a private foundation,
2. a governmental entity that are not subject to taxation,
3. a foreign organization exempt under Section 501(c)(3) or 501(c)(4) that receive substantially all of their support from sources outside the United States, or
4. an organization with exemptions that have been revoked, unless the revocation was based on inurement or private benefits.

This discussion summarizes:

1. the taxation provisions related to alleged "excess benefit" transactions,
2. the excise tax penalties that can be imposed on these prohibited transactions, and

3. the practical procedures that TEHCO managements/directors and TEHCO valuation/financial advisors should consider in order to avoid the imposition of these sanctions.

The management/board of a TEHCO, its independent valuation/financial advisor, and its other professional advisors should be aware of:

1. the restrictions related to the conduct of excess benefit transactions,
2. the specific penalties imposed by Section 4958, and
3. the appropriate procedures to avoid the Section 4958 excess benefit intermediate sanctions.

Of course, the Service may impose Section 4958 sanctions on excess benefit transactions in any tax-exempt entity. However, in recent years, the Service has paid particular attention to the investigation of excess benefit transactions with regard to a TEHCO.

HISTORICAL PERSPECTIVE ON INTERMEDIATE SANCTIONS

Historically, the revocation of an entity's tax-exempt status was the action of last resort with regard to the Service's challenge of Sections 501(c)(3) and 501(c)(4) tax-exempt organizations. If a TEHCO (1) paid a disqualified person

an unreasonable amount of compensation or (2) paid more than fair market value (FMV) for an economic benefit, then the Service threatened to revoke the entity's tax-exempt status. Such questionable transactions are typically referred to as "private inurement" transactions.

In response to private inurement transactions, effectively, the Service could either:

1. reprimand the tax-exempt organization but effectively ignore the subject transaction or
2. rescind the subject entity's tax-exempt status.

Therefore, even relatively minor private inurement transactions could create the risk of rescission of the not-for-profit organization's tax-exempt status.

The Taxpayer Bill of Rights legislation provided the Service with a less extreme penalty in dealing with private inurement transactions. This is particularly true when the private inurement transaction is due to the inappropriate actions of one, or a few, officers, executives, or directors.

This less extreme penalty is the Section 4958 excise tax that can be specifically imposed on the offending "person of influence" in the subject TEHCO. The Section 4958 excise tax reduces the risk that an excess benefit transaction will trigger the revocation of the offending TEHCO's tax-exempt status.

This Section 4958 legislation is often referred to as "intermediate sanctions." This is because the intermediate sanctions represent an alternative between (1) the Service's inaction and (2) the Service's revocation of the offending entity's tax-exempt status. Accordingly, these intermediate sanctions are particularly relevant for a TEHCO that may be involved with potential private inurement transactions.

A SUMMARY OF INTERMEDIATE SANCTIONS

Section 4958 and the regulations related to Section 4958—that is, Regulations Section 53.4958—are the primary authority for the Service's imposition of intermediate sanctions.

According to the Congressional Committee Reports, the Section 4958 excise penalty tax should be the only sanction imposed on a private inurement transaction—if the subject transaction is not so significant that it brings into question whether the subject organization is still charitable in its focus and mission.

Definition of Private Inurement and Excess Benefit Transactions

Section 4958(c)(1)(A) specifically defines an excess benefit transaction as follows:

[A]ny 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 benefit's value exceeds the value of the consideration (including the performance of services) received for providing such benefit.

The regulations related to Section 4958 (i.e., Regulations 53.4958-4 and 5) describe three broad categories of excess benefit transactions. These three categories are:

1. unreasonable level of compensation payments,
2. the tax-exempt organization purchase of assets from a "disqualified person" for an amount greater than the assets' FMV, and
3. a payment to a "disqualified person" that violates the private inurement provisions, such as certain revenue-sharing transactions.

Definition of a Disqualified Person

Section 4958(f)(1)(A) defines a disqualified person as an insider (e.g., an officer, employee, director, or trustee) who exercises "substantial influence" and control over the TEHCO. A person is an insider if he or she can potentially deal with the TEHCO on a non-arm's-length basis because of that "substantial influence."

This "substantial influence" would allow the disqualified person to reap "excess benefits" normally not possible for a person without such influence. It is noteworthy that, according to the Service, a person does not need to actually exercise "substantial influence." He or she needs only be in a position where it is possible to do so.

Under Regulation 53.4958-3(c), a person is considered to exercise "substantial influence" over the TEHCO if he or she is:

1. a voting member of the tax-exempt entity's governing body;
2. the president, CEO, or chief operating officer;
3. the treasurer or CFO; or
4. a person with a material financial interest in a provider-sponsored organization.

According to Regulation 53.4958-3(E), entity-specific facts and circumstances may suggest that a person can exercise substantial influence if that person:

1. founded the tax-exempt organization;
2. is a substantial contributor to the tax-exempt entity;
3. is compensated based primarily on the organization's revenue;

4. has or shares authority to control the tax-exempt entity's capital expenditures;
5. manages a discrete segment of the tax-exempt entity that represents a substantial portion of its activities, assets, income, or expenses;
6. owns a controlling interest in the subject tax-exempt entity; or
7. is a nonstock tax-exempt organization that is controlled by a disqualified person.

Certain family members of a disqualified person are also disqualified under Section 4958(f)(1)(B). Under Regulation 4958-3(b), a disqualified person's family is limited to (1) a spouse; (2) brothers, sisters, and their spouses; (3) ancestors; (4) children and their spouses; and (5) grandchildren, great-grandchildren, and their spouses.

Also under Section 4958(f)(1)(C), an entity that is 35 percent controlled by a disqualified person is also disqualified. In addition, any person who has met any of these definitions at any time during the five years preceding the alleged excess benefit transaction is also a disqualified person.

In contrast, the following entities and/or individuals are considered to have no "substantial influence" for purposes of Section 4958:

1. Section 501(c)(3) tax-exempt organizations,
2. certain Section 501(c)(4) tax-exempt organizations, or
3. an employee who is not a person of influence listed above and is not considered highly compensated under Section 414(q).

PRIVATE INUREMENT AND THE REASONABLENESS OF COMPENSATION OF A DISQUALIFIED PERSON

To determine if there is an excess benefit related to a disqualified person, the valuation/financial advisor may have to assess the reasonableness of that person's compensation under Regulation 53.4958-4(b)(1)(ii). In this regard, the typical procedures for testing the reasonableness of executive/employee compensation apply. The test for determining the reasonableness of executive/employee compensation include compensation comparisons with persons who perform similar functions at similar organizations.

According to Regulation 53.4958-6(c)(2), the subject disqualified person's compensation may be compared (1) to current salary surveys compiled by independent consulting firms or (2) to actual written hire offers from similar institutions for the subject disqualified person.

If property transfers are part of the employee compensation, then the property's FMV may be compared (1) to independent property appraisals or (2) to purchase offers for the property that are received as part of a competitive bidding process.

As there are with regard to a for-profit entity reasonableness of compensation dispute, there are several factors that tend to support the reasonableness of compensation with regard to a TEHCO. For example, a disqualified person's compensation package that involves a maximum limit or cap supports the presumption of reasonableness.

The fact that a state or local legislative agency or independent board approves the disqualified person's compensation package supports the reasonableness of compensation paid by the TEHCO. For example, Regulations 53.4958-6(a) through (c) outline a rebuttable presumption that a compensation arrangement with a disqualified person is reasonable if the following three factors are present:

"The Service has formulated a 'rebuttable presumption checklist' for both compensation levels and property transfers as a guide. . . ."

1. The compensation package is approved in advance by an authorized body of the TEHCO (e.g., by a board of directors or trustees or a special committee). This is true as long as this body is staffed with individuals who do not have personal conflicts of interest (e.g., they will not personally benefit from a transaction or are not subordinates of the subject disqualified person).
2. The authorized body investigates the compensation levels of persons who perform similar functions in similar organizations.
3. The authorized body documents the comparability of the subject disqualified person's compensation level with similar organizations.

Pursuant to Regulation 53.4958-6(b), the Service can rebut the presumption of reasonableness only if there is sufficient evidence to indicate that the information the authorized body relied upon was not reliable. The Service has formulated a "rebuttable presumption checklist" for both compensation levels and property transfers as a guide to meet the requirements for establishing the Regulation's rebuttable presumption.

In addition, a TEHCO with average annual gross receipts under \$1 million during the three prior tax years may use a special rule when reviewing a disqualified person's compensation levels. In this circumstance, Regulation 53.4958-6(c)(2)(ii) indicates the following:

[t]he authorized body will be considered to have appropriate data as to comparability if it has data on compensation paid by three comparable orga-

nizations in the same or similar communities for similar services.

THE DISQUALIFIED PERSON EXCESS COMPENSATION AND THE SECTION 4958 EXCISE TAX

Virtually all forms of cash and noncash compensation are subject to the Section 4958 excise tax. For purpose of the Section 4958 excise tax, compensation includes employee benefits (including employee benefits that are not considered taxable income to the employee).

However, under Regulation 53.4958-4(a)(4), certain specified forms of compensation are not considered for Section 4958 excise tax purposes. These excluded forms of employee compensation include:

1. most nontaxable employee fringe benefits under Section 132,
2. employee expense reimbursements under an accountable plan, and
3. benefits of \$75 or less provided to the tax-exempt organization volunteers or board members.

Section 4958(a) and (b) impose an excise penalty tax on each excess benefit transaction that involves (1) a TEHCO and (2) a disqualified person. Under Section 4958, a disqualified person may be subject to two tiers of excise tax. Under Section 6501, a disqualified person is subject to this excise tax only during a three-year statute of limitations. The three-year statute of limitations applies unless the Service finds that fraud is involved.

Section 4958(a)(1) imposes an initial 25 percent excise tax to the total amount of excess benefit. In addition, the disqualified person is subject to an additional excise tax under Section 4958(b). This additional excise tax is 200 percent of the excess benefit received if the excess benefit transaction is not corrected within the tax period. Also, if a disqualified person pays less than the full excess benefit correction amount, Regulation 53.4958-7 provides that the 200 percent excise tax will only be applied against the unpaid correction amount.

The subject disqualified person is not the only person who may be liable for the Section 4958(a)(2) and (f)(2) excise tax. A TEHCO manager (e.g., the tax-exempt entity's officers/director/trustee or anyone with similar authority over the tax-exempt entity) who knowingly participates in an excess benefit transaction also faces a 10 percent excise tax. This 10 percent excise tax is based on (1) the amount of the excess benefit received over (2) the FMV of the benefits received.

Under Regulation 53.4958-1(d)(7), this managerial excise tax cannot be greater than \$10,000. Also, under

Regulation 53.4958-1(a), the TEHCO manager may be liable for a 25 percent excise tax if he or she also personally received an excess benefit.

A TEHCO manager may escape the 10 percent excise tax if he or she can show that participation in the subject excess benefit transaction (1) was not willful and (2) was due to reasonable cause. Willful participation is defined in Regulation 53.4958-1(d)(5) as "voluntary, conscious, and intentional." Under Regulation 53.4958-1(d)(6), participation in the excess benefit transaction is considered to be due to "reasonable cause" as long as the TEHCO manager exercised ordinary business responsibility, care, and prudence.

Pursuant to Regulation 53.4958-1(d)(4), the TEHCO manager knowingly participates in the excess benefit transaction only if he or she:

1. has actual knowledge of the facts regarding the excess benefit transaction,
2. is aware that the excess benefit transaction may violate the federal tax law, and
3. fails to reasonably attempt to determine whether the subject transaction results in an excess benefit, or knows that the subject transaction is an excess benefit transaction.

A TEHCO manager is deemed to participate in an excess benefit transaction if he or she is actively involved in that transaction. In addition, under Regulation 53.4958-1(d)(3), a manager is deemed to participate in the excess benefit transaction:

1. if he or she does nothing about the excess benefit transaction or
2. remains silent when under a duty to speak or act based on his or her management function in the TEHCO.

However, a TEHCO manager who is opposed to the excess benefit transaction is not considered to be a participant and should carefully document his or her opposition (e.g., by way of a memorandum to the subject entity's board).

THE APPROPRIATE CORRECTION OF AN EXCESS BENEFIT TRANSACTION

A disqualified person may avoid the 200 percent second-tier excise tax if he or she ensures that the excess benefit transaction is corrected. The timing of the transaction correction is important. The excess benefit transaction correction must be implemented in the same tax period as the subject private inurement. Section 4958(f)(5) defines the tax period as the period:

1. beginning with the date of the excess benefit transaction and
2. ending on the earlier of the (a) mailing of the deficiency notice or (b) date of the 25 percent excise tax assessment.

Regulation 53.4958-7(a) defines an excess benefit transaction correction as follows:

[U]ndoing the excess benefit to the extent possible, and taking any measures necessary to place the applicable tax-exempt organization involved in the excess benefit transaction in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.

According to Regulation 53.4958-7(c), the appropriate correction amount equals the sum of (1) the excess benefit amount and (2) the associated interest. Under Regulation 53.4958-7(b), a disqualified person corrects the excess benefit transaction only by “making a payment in cash or cash equivalents, excluding payment by a promissory note.” A disqualified person may also agree with the subject TEHCO to “make a payment by returning specific property previously transferred in the excess benefit transaction.”

SECTION 4958 EXCISE TAX REPORTING REQUIREMENTS

Both the disqualified person and the TEHCO manager subject to the Section 4958 excise tax have to file Form 4720, “Return of Certain Excise Taxes on Charities and Other Persons under Chapters 41 and 42 of the Internal Revenue Code.” These individuals may file Form 4720 jointly with the TEHCO if the individuals and the entity have the same tax year. The subject individuals should file a separate Form 4720 if their tax year differs from the tax year of the TEHCO.

Form 4720 is due by the 15th day of the fifth month after the close of the disqualified person’s—or the entity manager’s—tax year (i.e., May 15 for all calendar-year taxpayers). If the TEHCO can show that the subject private inurement is due to “reasonable cause” and not due to “willful neglect,” then the entity can petition the Service to abate the associated excise taxes.

According to Regulation 301.6724-1, “reasonable cause” exists if:

1. there are significant mitigation factors with respect to the failure,
2. the failure arose from an event beyond the filer’s control, or

3. the filer acted in a responsible manner both before and after the failure.

In addition, the TEHCO must also act with “reasonable care.” “Willful neglect” exists if there is “a conscious, intentional failure or reckless indifference.”¹

PRACTICAL PROCEDURES FOR TAX-EXEMPT ENTITY MANAGERS TO AVOID INTERMEDIATE SANCTIONS

The Service’s imposition of intermediate sanctions often creates economic trauma both for the disqualified person and for the TEHCO. Independent financial advisors (and other legal/accounting professionals) should explain the Section 4958 excise tax issues to the tax-exempt officers and directors.

The TEHCO advisors should also explain to entity officers and directors exactly how the intermediate sanctions may apply to each individual’s facts and circumstances. Such professional advice may increase the awareness of the TEHCO officers/directors with regard to the risks of non-compliance with the excess benefit transaction rules.

One practical procedure that valuation/financial advisors can use to educate TEHCO officers and directors is the benchmarking process. The benchmarking process is often used to develop internal documentation with regard to possible excess benefit transactions.

This benchmarking process is typically implemented by a series of analytical procedures. The typical analytical procedures will be summarized below.

Analytical Procedure #1: Obtain Data from Similar TEHCOS

This procedure involves identifying guideline tax-exempt organizations that are similar to the subject entity based on comparability criteria. These comparability criteria may include: size (i.e., historical revenue, budgeted revenue, assets, number of employees, etc.), mission, and location.

Valuation/financial advisors often obtain relevant financial information on guideline TEHCOS from Internal Revenue Service Form 990, “Return of Organizations Exempt from Income Tax,” and the respective entity’s audited financial statements. The financial information reported on Form 990 for the guideline TEHCO is available at www.guidestar.org, the Web site of The National Database of Nonprofit Organizations. In addition, a TEHCO’s Form 990 may be obtained from the Service’s Web site or directly from the guideline TEHCO itself.

Analytical Procedure #2: Compare the Financial Metrics of the Guideline TEHCOS to the Subject TEHCO

The basic financial ratios of the guideline TEHCOS (or of the subject entity) may not explicitly identify a specific excess benefit as a transaction that is subject to Section 4958. However, comparative financial ratio analysis may be used by the subject entity officers/directors or by their valuation/financial advisors to identify potential excess benefit transactions.

One common comparative financial ratio analysis contrasts over time (1) the guideline entity ratios to (2) the subject entity ratios. A second common comparative financial ratio analysis contrasts (1) subject entity current financial/operating results to (2) subject entity historical financial/operational results.

These various comparative financial ratio analyses should allow the subject TEHCO officers/directors (and/or their valuation/financial advisors) to identify potential excess benefit transactions.

Analytical Procedure #3: Review the Compensation and Employee Benefits Paid by the Guideline TEHCOS

An analysis of the compensation levels actually paid to similar employees at similar TEHCOS is an important procedure in avoiding excess benefit transaction allegations. Valuation/financial advisors often obtain such salary information from published industry-specific salary surveys related to TEHCOS.

In addition, Internal Revenue Service Form 990, Schedule A, "Organizations Exempt Under Section 501(c)(3)," reports the compensation, employee benefits, and expense allowances for officers, directors, trustees, and the five highest-paid employees of the TEHCO.

Analytical Procedure #4: Document Guideline TEHCO Compensation

Valuation/financial advisors should document compensation data related to the guideline TEHCOS. Valuation/financial advisors should assemble actual compensation amounts paid to persons who perform similar functions in similar TEHCOS, adjusted for any relevant local and regional differences.

The authorized body of the subject TEHCO may approve the compensation level for the disqualified persons based on a documented analysis of the empirical compensation levels of the guideline TEHCO. ("Small" TEHCOS with annual average gross receipts of less than \$1 million during the last three years should be aware of the Regulation 53.4958-6(c)(2) provisions.)

Analytical Procedure #5: Review of All Incentive or Contingent Compensation Agreements

Currently, TEHCOS commonly use incentive (or contingent) compensation plans with regard to officers and other senior executives. This is particularly true as TEHCOS have to compete with for-profit industrial and commercial firms to recruit senior executive talent.

There is no clear implication that incentive or contingent compensation packages result in private inurement. Nonetheless, the subject TEHCO board or a special compensation committee should carefully review such incentive compensation plans. In particular, the directors should document how such compensation plans support the subject TEHCO's mission. In addition, the board or special compensation committee should document how the subject incentive plan is supported by compensation levels paid by similar TEHCOS for similar executives.

The subject TEHCO officers/directors should be aware that such contingent compensation or revenue-sharing arrangements with a disqualified person increases the entity's exposure to intermediate sanctions. This is because these contingent arrangements generally involve a person of influence receiving compensation based directly or indirectly on the subject TEHCOS revenue.

According to several Service general counsel memorandums, TEHCO revenue-sharing compensation arrangements do not necessarily constitute private inurement. Nonetheless, the subject TEHCOS valuation/financial advisor (or other professional advisors) should carefully investigate the details of each revenue-sharing compensation agreement.

For example, a revenue-sharing compensation arrangement is a common arrangement between physicians and not-for-profit hospitals. For excess benefit purposes, the Service has ruled that all physicians in such situations are insiders. Nonetheless, Congress has decided that a physician will only be considered a disqualified person if he or she "exercises substantial influence" over the TEHCO. For example, if a physician's compensation is based on revenue from activities the physician controls, the physician may be considered to have "substantial influence" on the TEHCO by the Service.

In any event, the TEHCO valuation/financial advisor should be prepared to prove that the contingent fee compensation arrangement is the only way the TEHCO can obtain the services (e.g., the physician services) it needs to accomplish its mission.

Analytical Procedure #6: Consider the Use of Employee Benefit and Reimbursement Plans

The subject TEHCO management should consider the use of Section 132 employee fringe benefits for insider compen-

sation arrangements. This is because Section 132 employee fringe benefits are generally not included in the definition of compensation subject to private inurement.

Common examples of Section 132 fringe benefits include: (1) no-additional-cost entity services, (2) qualified employee discounts, (3) “working condition” fringe benefits, (4) de minimis fringe benefits, (5) qualified transportation benefits, and (6) qualified moving expense reimbursements.

In addition, many TEHCOS make use of accountable reimbursement plans. This is because such accountable reimbursements are also excluded from the definition of private inurement. The valuation/financial advisors can help set up and implement these accountable reimbursement plans.

Analytical Procedure #7: Review the Amounts Paid for Products or Services from a Disqualified Person to the Subject TEHCO

Valuation/financial advisors to a TEHCO should review all business services provided by board members, trustees, or related parties to the TEHCO. This review is appropriate because this is an area the Service often looks at when identifying excess benefit transactions.

It is not uncommon for individuals who work for for-profit industrial or commercial companies to sell products or services to the TEHCO for which they serve as board members. Sometimes, the products or services are substantially discounted or donated to the not-for-profit organization.

However, if the products or services are sold to the TEHCO, then the valuation/financial advisor should review the consideration paid. This review should ensure that the consideration compares to the FMV of similar products or services received. When these consideration amounts are material and when the FMV for such goods or services is difficult to ascertain, it may be appropriate for the TEHCO to obtain an independent appraisal before entering into such transactions.

Analytical Procedure #8: Valuation/Financial Advisor Should Review the Amount of Compensation Paid to Board Members

The compensation and reimbursement amount paid to TEHCO directors or trustees must be disclosed on the subject entity’s Form 990. Many TEHCOS avoid the reasonableness of compensations issue altogether as to their board members. This is because these TEHCOS do not compensate their all-volunteer board of directors.

However, many TEHCOS have to compensate board members in order to attract the time and talent of appropri-

ately qualified individuals. In such instances, the TEHCO valuation/financial advisor should attempt to find a similar TEHCO that pays its board compensation and to document that comparison. This comparative analysis is intended to demonstrate that the subject TEHCO director’s compensation is not unreasonable.

SUMMARY AND CONCLUSION

TEHCO officers and directors (particularly those related to health care institutions) should be generally concerned with all corporate governance issues. These health care entity officers and directors should also be concerned with transactions that may be considered excess benefit transactions.

To allay these concerns, the TEHCO management should periodically engage independent consultants (such as independent valuation/financial advisors) to review the entity’s written policies and procedures. In particular, independent valuation/financial advisors should review the TEHCO’s policies and procedures (1) for compensation and (2) for transactions with disqualified persons.

For example, the valuation/financial advisor may recommend that the TEHCO board adopt a written conflict-of-interest policy that prohibits any actions that could trigger the imposition of intermediate sanctions.

The TEHCO officers and directors should periodically review all compensation arrangements and financial transactions with potentially “disqualified persons.” The objective of such a periodic review is to identify areas of possible exposure to “private inurement.”

The objective of the above-described practical procedures is to minimize the risk that the Service will impose intermediate sanctions on the subject health care entity.

In addition, the TEHCO officers, directors, and trustees (and their valuation/financial advisors) should (1) be on the lookout for and (2) avoid private inurement situations and excess benefit transactions. This level of officer/director/advisor awareness and avoidance should minimize the risk that the Service will impose intermediate sanctions on the subject TEHCO.

Note:

1. *United States v. Boyle*, 469 U.S. 241 (1985).

Robert Reilly is a managing director of the firm and is resident in the Chicago office. Robert can be reached at (773) 399-4318 or rfreilly@willamette.com.

Ashley Reilly is an intern of the firm and is also resident in the Chicago office..