

**THE NEW INTERMEDIATE SANCTIONS REGULATIONS:
WHAT BOARDS NEED TO KNOW**

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The newly released final Intermediate Sanctions Regulations¹ have material implications for the governing boards of nonprofit, tax-exempt organizations. These implications relate not only to the oversight obligations of board members, but also to their potential individual tax exposure for participation in/approval of “excess benefit” transactions. In addition, the conduct addressed in the final Regulations has direct application to compliance with state nonprofit corporation law. For these and other reasons, the governing board and executive management are likely to benefit from a briefing by the general counsel on this important new development.

Overview

The principal purpose of the final Regulations is to clarify the relationship between the substantive requirements for Internal Revenue Code (IRC) Sec. 501(c)(3) tax-exempt status, and the imposition of excise taxes on excess benefit transactions under IRC Sec. 4958 (a/k/a the “Intermediate Sanctions” provisions). To that end, the final Regulations provide guidance on certain factors to be considered by the Internal Revenue Service (IRS) in determining whether an IRC 501(c)(3) organization may jeopardize its tax-exempt status by engaging in one or more excess benefit transactions. In addition, the final Regulations also seek to clarify the prohibition against

¹ Standards for Recognition of Tax-Exempt Status if Private Benefit Exists, 73 Fed. Reg. 16519-16525 (Mar. 28, 2008).

excess private benefit under IRC 501(c)(3) status, and how prohibited private benefit may jeopardize an organization's tax exemption.

Intermediate Sanctions: The fundamental goal of the Intermediate Sanctions provisions is to penalize disqualified persons/"insiders" who benefit from their control of an exempt organization (i.e., by receiving excessive economic benefits from the organization), without penalizing the organization itself (e.g., by revocation of tax-exempt status).² Generally speaking, IRC 4958 applies an initial excise tax of 25% of the value of the excess benefits the organization provides to the insider, and applies a "second tier" tax of 200% of the excess benefit if the action is not corrected within a specified time period.³ Furthermore, a separate excise tax of 10% on the excess benefit (with a cap of \$20,000) is imposed on an "organizational manager" who knowingly participated in the excess benefit transaction, and that participation was willful and not due to reasonable cause.⁴ However, both Congress and the IRS have long made clear that the imposition of intermediate sanctions excise taxes does not automatically preclude the IRS from acting to revoke the organization's tax-exempt status.

Private Benefit: The prohibition against excess private benefit is based on that portion of IRC 501(c)(3) that requires an exempt organization to be "organized and operated" exclusively for charitable purposes. Treasury Regulations provide that: (a) an organization will be regarded as operated exclusively for exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes; and (b) that an IRC 501(c)(3) organization must serve:

. . . public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish it is not organized or operated for the benefit of private interests such as designated individuals . . .

² Janet E. Gitterman and Marvin Friedlander, Health Care Provider Reference Guide, IRS EXEMPT ORGANIZATIONS PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FY 2004, at p. 11; www.irs.gov/pub/irs-tege/eotopice04.pdf.

³ Lawrence M. Brauer and Leonard J. Henzke, "Intermediate Sanctions (IRC 4958) Update," Internal Revenue Service Continuing Professional Education Textbook (FY 2003); www.irs.gov/pub/irs-tege/eotopice03.pdf.

⁴ Lawrence M. Brauer, Toussaint T. Tyson, Leonard J. Henzke, and Debra J. Kaweski, "An Introduction to I.R.C. 4958 (Intermediate Sanctions)," Internal Revenue Service Continuing Professional Education Textbook (FY 2002); www.irs.gov/pub/irs-tege/eotopice02.pdf.

Unlike private inurement, private benefit involves benefits flowing to anyone, not just insiders. Private benefit will create a tax exemption concern only if it is more than incidental, as measured from qualitative and quantitative perspectives.⁵

Specific Governance Implications

In its focus on the relationship between intermediate sanctions, excess private benefit and revocation, the final Regulations suggest at least ten significant governance themes that the board “needs to know”:

1. *A Big Ticket Item*: As part of its fundamental obligation to exercise oversight over day-to-day operations, the governing board must maintain a general awareness of the legal risk profile of the organization. (In this task it may rely upon the advice of the general counsel and qualified outside counsel, but the board should assure that it has direct access to that advice). For an IRC 501(c)(3) or (4) organization, there is significant direct and collateral value attributable to tax-exempt status. Guidance addressing the potential for revocation of tax-exempt status could thus reasonably be considered relevant to that legal risk profile; i.e. a potential “big ticket item.” In that regard, the final Regulations speak to not just one, but two general classes of such circumstances—*first*, when one or more excess benefit transactions may jeopardize exempt status, and *second*, where excess private benefit provides an independent basis for revocation (even in the absence of economic benefit, or fair market value concerns). Specific examples (“Examples”) are provided of circumstances where revocation may be warranted. Accordingly, it is fair to assume that the board would expect to be briefed on such a material regulatory development providing guidance on conduct that could jeopardize tax-exempt status.

2. *It's Their Skin*: Treasury Regulations make it explicitly clear that the terms “disqualified person” and “organizational manager” include voting members of the governing board. Thus, it is technically possible

⁵ See *supra* note 2.

that, depending upon the circumstances, a governing board member can be implicated in an excess benefit transaction both on the “receiving end” (i.e., as a disqualified person receiving the benefits of the transaction), as well as on the “approving end” (i.e., by voting to approve the excess benefit transaction, knowing (unreasonably) it to be so). Because of the potential personal liability and unfavorable publicity, it makes sense that board members would be acutely interested in any new guidance on its application of the Intermediate Sanctions rules.

3. *The Caremark Connection*: Under the *Caremark*⁶ and *Stone*⁷ decisions, directors have a basic duty of care obligation with respect to corporate compliance; i.e., to implement and maintain an effective compliance plan for the organization. The final Regulations provide that an important factor to be considered by the IRS in the revocation analysis is “[W]hether the organization has implemented safeguards that are reasonably calculated to prevent excess benefit transactions.” It matters not whether such safeguards are implemented in direct response to a particular excess benefit transaction, or are pre-existing, “as a general matter of corporate governance or fiscal management.” The Examples suggest that such safeguards could include effecting contract review procedures, and satisfying the rebuttable presumption of reasonableness, before approving a transaction that implicates the Intermediate Sanctions rules. The emphasis in the final Regulations on the adoption of safeguards implicates the *Caremark* duty, and thus should be of significant interest to the board and, especially, to Compliance Committee members.

4. *Compliance Plan Premium*: The final Regulations provide that the IRS will favorably consider circumstances where the organization discovers the excess benefit transaction and takes action before the IRS discovers the excess benefit transaction. On the other hand, correction of the excess benefit transaction after the IRS discovers it will not, by itself,

⁶ *In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

⁷ *Stone v. Ritter*, 2006 Del. LEXIS 597 (Nov. 6, 2006).

serve as a “sufficient basis” for preserving the organization’s exempt status. By this provision, the IRS indirectly places a premium on effective tax-exemption compliance activity (potentially increasing the scope of responsibilities of the corporate compliance office). This may well be useful information for the board, its Compliance Committee, and the chief compliance officer.

5. *Rebuttable Presumption, Repeated*: The final Regulations serve as additional evidence of the value attributed to good faith attempts by an organization to satisfy the rebuttable presumption of reasonableness in connection with transactions or arrangements that implicate the Intermediate Sanctions rules. Some tax-exempt organizations have been reluctant to apply the “rebuttable presumption,” in part due to the costs (e.g., consultant fees) attributable to obtaining appropriate comparability information. The governing board should be made aware of the extent to which the IRS is encouraging tax-exempt organizations to rely on the rebuttable presumption,⁸ and should give close consideration to adopting a policy that requires its satisfaction in relevant transactions and arrangements.

6. *Calling the “Comp” Committee*: One of the most significant changes incorporated into the final Regulations is the addition of Example Six, which addresses an executive compensation scenario. This Example describes circumstances in which committee reliance on inappropriate comparability data would result in excess benefit exposure, despite the fact that the compensation review process was otherwise properly structured (e.g., committee composed of disinterested directors, an attempt to satisfy the rebuttable presumption). While the organization described in Example Six was ultimately able to avoid revocation of exempt status, its travails provide a cautionary tale worthy of notice to the board’s executive compensation committee.

⁸ Governance and Related Topics – 501(c)(3) Organizations (Feb. 14, 2008); www.irs.gov/charities/article/0,,id=178221,00.html.

7. Expense Account Excitement: A topic currently of great interest to charity regulators and the media alike is the perception of abuse of travel, entertainment, and discretionary expense reimbursement by executives and board members of nonprofit organizations. The reimbursement process, particularly to the extent that it involves board member participation in the approval process (e.g., the board chair approving expense reimbursement of the chief executive officer), has particular Intermediate Sanctions implications. The final Regulations may thus serve as a “prompt” to governance and executive leadership to review the effectiveness of the expense reimbursement process.

8. Making the Tough Call: The final Regulations emphasize the importance attributed by the IRS in the revocation analysis to good faith efforts of the organization at corrective action. This may take the form of actually correcting the excess benefit transaction, or making a good faith effort to seek correction from the disqualified person/“insider” who benefited from the excess benefit transaction. Other types of corrective action referenced in the Examples include amending board policies and procedures (e.g., the compensation committee process, existing conflicts policies), restructuring the compensation committee, renegotiating compensation agreements, removal of the chief executive officer, and, in the extreme circumstance, removing the entire board. In this regard, consideration should be given to the extent of correction in relation to the severity of the underlying circumstances. Obviously, these types of material corrective actions have significant legal, organizational, and political ramifications. Nevertheless, it is important that the board be made aware of what may constitute effective corrective action in an excess benefit transaction scenario, particularly when the circumstances suggest that tax exemption may be at risk.

9. Two for the Price of One: It is equally important from a “risk profile” perspective for the board to recognize that the types of problematic conduct identified in the final Regulations may also create individual and

organizational exposure under state nonprofit corporation and charitable trust laws. Contracts, transactions, and arrangements that implicate the Intermediate Sanctions rules can also implicate the fiduciary duties of care and loyalty in general; and state statutory waivers of conflicts of interest, and statutory and common law proscriptions against self dealing and waste of charitable assets in particular. Board acquiescence or inattentiveness to multiple “excess benefit”-type transactions could prompt state charity officials to seek significant equitable relief (e.g., removal, surcharge, accounting) against the board or individual members thereof.

10. *There’s a Trend Here*: It may also be valuable for the board to evaluate the final Regulations in the broader context of recent IRS activity with respect to tax-exempt organizations. For example, the last four months have witnessed the release of the dramatically revised Form 990 (December, 2007) and the publication of a new position paper updating and consolidating the IRS’ view on the governance of IRC 501(c)(3) organizations (February 2008).⁹ In addition, senior IRS exempt organizations officials have in recent public speeches highlighted perceived deficiencies in governance of nonprofit organizations. Particular concern has been expressed with respect to a “sense of entitlement” by some organizational insiders who are not held accountable by governance.¹⁰

In these and other ways, the final Regulations should be of significant interest to the governance and executive leadership of nonprofit, IRC 501(c)(3) and (4) organizations. Notably, the final Regulations specifically decline to provide any specific “best practices” which nonprofit organizations and their boards may adopt in response

⁹ *Id.*

¹⁰ Remarks of Steven T. Miller, Commissioner, Tax Exempt and Government Entities, Internal Revenue Service, before Independent Sector, Los Angeles, California, Oct. 22, 2007 (Miller 10/22/07 Remarks); Remarks of Steven T. Miller, “The IRS’s Role in an Evolving Charitable Sector,” before the Philanthropy Roundtable, Nov. 10, 2007 (Miller 11/10/2007 Remarks); *Id.* See also “Senators Express Concern over Charitable Abuse, Cite Opportunity to Protect Charities” (July 23, 2007); www.senate.gov/~finance/press/Gpress/2007/prg072307.pdf.

to improve governance and prevent excess benefit transactions. However, our view is that the Regulations, and the Examples contained therein, provide multiple bases for corporate leadership (working in consultation with the general counsel) to develop meaningful responsive policies and procedures.

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