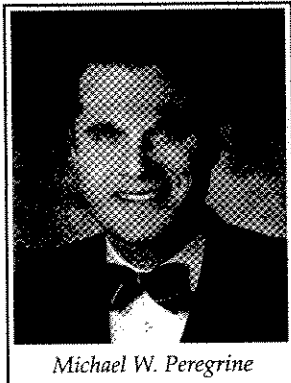


The New Intermediate Sanctions Regulations: What Boards Need to Know

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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 or approval of excess benefit transactions. Also, 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 section 501(c)(3) status and the imposition of excise taxes on excess benefit transactions under section 4958 (intermediate sanctions). To that end, the final regulations provide guidance on factors to be considered by the IRS in determining whether a section 501(c)(3) organization may jeopardize its tax-exempt status by

engaging in one or more excess benefit transactions. Also, the final regulations seek to clarify the prohibition against excess private benefit under section 501(c)(3) 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 (in other words, by receiving excessive economic benefits from the organization), without penalizing the organization itself (for example, by revocation of exempt status).² Generally, section 4958 applies an initial excise tax of 25 percent of the value of the excess benefits the organization provides to the insider and applies a second tier tax of 200 percent of the excess benefit if the action is not corrected within a specified period.³ Further, a separate excise tax of 10 percent on the excess benefit (with a cap of \$20,000) is imposed on an organizational manager who knowingly and willfully participated in the excess benefit transaction.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 revoking an organization's exempt status.

Private Benefit

The prohibition against excess private benefit is based on the portion of section 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

²Janet E. Gitterman and Marvin Friedlander, Health Care Provider Reference Guide, *IRS Exempt Organizations Professional Education Technical Instruction Program for FY 2004*, at p. 11; <http://www.irs.gov/pub/irs-tege/eotopice04.pdf>.

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

⁴Lawrence 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); <http://www.irs.gov/pub/irs-tege/eotopice02.pdf>.

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

exclusively for exempt purposes only if it engages primarily in activities that accomplish one or more exempt purposes; and (b) that a section 501(c)(3) organization must serve:

... a 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.

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 their focus on the relationship between intermediate sanctions, excess private benefit, and revocation, the final regulations suggest at least 10 significant governance themes that the nonprofit 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 on the advice of the general counsel and qualified outside counsel, but the board should assure that it has direct access to that advice.) For a section 501(c)(3) or (c) (4) organization, there is significant direct and collateral value attributable to tax-exempt status. Guidance addressing the potential for revocation of exempt status could thus reasonably be considered relevant to that legal risk profile; in other words, 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*, when excess private benefit provides an independent basis for revocation (even in the absence of economic benefit or fair market value concerns). Specific examples are provided of circumstances in which 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 exempt status.
2. **It's Their Skin.** Treasury regulations make it clear that the terms "disqualified person" and "organizational manager" include voting members of the governing board. Thus, it is technically possible

that, depending on the circumstances, a governing board member can be implicated in an excess benefit transaction both on the "receiving end" (in other words, as a disqualified person receiving the benefits of the transaction) as well as on the "approving end" (in other words, 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 the 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 regarding corporate compliance; in other words, 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 "whether 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 preexisting "as a general matter of corporate governance or fiscal management." The examples suggest that safeguards could include adopting contract review procedures and satisfying the rebuttable presumption of reasonableness before approving a transaction that triggers 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 in which the organization discovers the excess benefit transaction and takes action *before* the IRS discovers the transaction. On the other hand, correction of the excess benefit transaction *after* the IRS discovers it will not, by itself, be a sufficient basis for preserving the organization's exempt status. By this provision, the IRS indirectly places a premium on effective 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.

⁵Fn. 2, *supra*.

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).

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 involve the intermediate sanctions rules. Some exempt organizations have been reluctant to apply the rebuttable presumption, in part due to the costs (for example, consultant fees) attributable to obtaining appropriate comparability information. The governing board should be made aware of the extent to which the IRS is encouraging exempt organizations to rely on the rebuttable presumption⁸ and should consider adopting a policy that requires its satisfaction in relevant transactions and arrangements.
6. **Calling the Compensation 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, even though the compensation review process was otherwise properly structured (for example, committee composed of disinterested directors, an attempt to satisfy the rebuttable presumption). While the organization described in example six ultimately was able to avoid revocation of exempt status, its travails provide a cautionary tale worthy of notice to the board's executive compensation committee.
7. **Expense Account Excitement.** A topic 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. For example, *The Washington Post* on April 14 reported that an investigation by the Office of the Inspector General at the Smithsonian Institution found that the director of the Smithsonian Latino Center had committed numerous ethical lapses, including soliciting and accepting gifts from companies wanting to do business with the Smithsonian and using her Smithsonian-issued travel card improperly.

The reimbursement process, particularly to the extent that it involves board member participation in the approval process (for example, 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 can be done by actually correcting the excess benefit transaction or making a good faith effort to seek correction from the disqualified person/insider who benefited from the transaction. Other types of corrective action referenced in the examples include amending board policies and procedures (for example, the compensation committee process, existing conflicts policies), restructuring the compensation committee, renegotiating compensation agreements, removing 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 activate the intermediate sanctions rules can also trigger the fiduciary duties of care and loyalty in general, as well as 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 transactions could prompt state charity officials to seek significant equitable relief (for example, removal, surcharge, accounting) against the board or individual members.
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 regarding exempt organizations. For example, the last four months have witnessed the release of the dramatically revised Form 990 (December, 2007), the publication of a new position paper updating and consolidating the IRS's view on the governance of section 501(c)(3) organizations (February 2008),⁹ and the release of proposed instructions to the redesigned Form 990.¹⁰ Also, senior IRS exempt organizations officials have in recent public

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

⁹*Id.*

¹⁰"IRS Publishes Draft Instructions for Revised EO Return, Seeks Comments," *The Exempt Organization Tax Review*, May 2008, p. 147.

speeches highlighted perceived deficiencies in governance of nonprofit organizations. Particular concern has been expressed regarding a "sense of entitlement" by some organizational insiders who are not held accountable by governance.¹¹

¹¹Remarks 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); <http://www.senate.gov/~finance/press/Gpress/2007/prg072307.pdf>.

In these and other ways, the final regulations should be of significant interest to the governance and executive leadership of section 501(c)(3) and (c)(4) organizations. Notably, the final regulations decline to provide any specific best practices that nonprofit organizations and their boards may adopt to improve governance and prevent excess benefit transactions. However, our view is that the regulations, and the examples 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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