Wolters Kluwer

WoltersKluwerLR.com/HCCPM

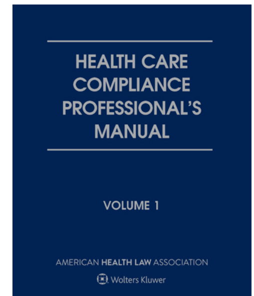
The Health Care Compliance Professional's Manual, Third Edition

Complimentary Sample Chapter: IRS Use of Intermediate Sanctions to Police Excess Benefit Transactions

Master the compliance strategies to safeguard your health care organization!

Written by compliance professionals and American Health Law Association members, the ***Health Care Compliance Professional's Manual*** gives you all the tools you need to plan and execute a customized compliance program that meets federal standards.

Call **1-866-529-6600** or visit **WoltersKluwerLR.com/HCCPM** to learn more.



Wolters Kluwer has partnered with AHLA on the new edition of the ***Health Care Compliance Professional's Manual***.

AVAILABLE ON CHEETAH AND MEDIREGS

Get more from the ***Manual*** with practical digital tools!

Contents

IRS Use of Intermediate Sanctions to Police Excess Benefit Transactions 2

Health Care Compliance Professional's Manual, ¶24,400, Introduction 2

Health Care Compliance Professional's Manual, ¶24,405, Overview of Section 4958 3

Health Care Compliance Professional's Manual, ¶24,410, Excess Benefit Transactions 4

Health Care Compliance Professional's Manual, ¶24,420, Valuation Standards 6

Health Care Compliance Professional's Manual, ¶24,430, Types of Penalty Excise Taxes and Correction Process 9

Health Care Compliance Professional's Manual, ¶24,440, Tests to Determine Disqualified Persons 10

Health Care Compliance Professional's Manual, ¶24,445, Organization Managers 14

Health Care Compliance Professional's Manual, ¶24,450, Establishing the Rebuttable Presumption 15

Health Care Compliance Professional's Manual, ¶24,455, Automatic Excess Benefit Transaction 17

Health Care Compliance Professional's Manual, ¶24,460, Reporting Obligations 18

Health Care Compliance Professional's Manual, ¶24,465, Revocation of Tax-Exempt Status 19

Health Care Compliance Professional's Manual, ¶24,470, Examples of Facts and Circumstances Test for Tax- Exempt Status 20

Health Care Compliance Professional's Manual, ¶24,475, Executive Compensation under Tax Cut and Jobs Act 21

Health Care Compliance Professional's Manual, ¶24,480, Conclusion 22

Health Care Compliance Professional's Manual, ¶24,485, Appendix A Rebuttable Presumption Checklist 23

Health Care Compliance Professional's Manual, ¶24,490, Appendix B Rebuttable Presumption Checklist Property 23

IRS Use of Intermediate Sanctions to Police Excess Benefit Transactions

Health Care Compliance Professional's Manual

Basics of the Law :: IRS Use of Intermediate Sanctions to Police Excess Benefit Transactions

Updated by Travis F. Jackson, Esq.

Health Care Compliance Professional's Manual, ¶24,400, Introduction

Health Care Compliance Professional's Manual ¶24,400

[*]In 1996, Congress enacted Internal Revenue Code (IRC) section 4958 ("Section 4958")[1] to "ensure that the advantages of tax-exempt status ultimately benefit the community and not private individuals."[2] Section 4958 imposes a series of penalty excise taxes whenever a tax-exempt organization enters into a transaction with officers, directors and others with such influence on terms that are not consistent with fair market value.[3] For example, if a charitable hospital sells property valued at $1 million to a director for only $500,000, the director has benefited improperly from the transaction by $500,000. Similarly, if the charitable hospital paid its president $100,000 more than the fair market value of the services he provides, the president has unfairly pocketed an extra $100,000 at the hospital's expense. Under prior law, the Internal Revenue Service (IRS) had only two choices when faced with such transactions—seek to revoke the tax-exempt status of the organization itself or take no action. Section 4958 provides an intermediate means of addressing improper transactions by allowing the IRS to penalize recipients of an improper payment and the person(s) within the organization who knowingly approve such transactions, rather than the organization itself. Tax-exempt organizations may not incur excise tax liability under Section 4958, but they must disclose and correct any excess benefit transactions to keep their tax-exempt status. After its enactment, officials at the IRS hailed Section 4958 as "the most important change in the federal income tax law relating to tax-exempt organizations in 30 years."[4] This Chapter summarizes Section 4958, describes IRS enforcement, and offers practical guidance for compliance.

Footnotes

* This chapter was written by James R. Wiley, Esq. shareholder of Carlton Fields Jorden Burt and Calvin R. Chambers Esq. associate at Hall, Render, Killian, Heath & Lyman, PC for the June 2009 quarterly report. The chapter has been updated by Travis F. Jackson, Esq. partner, King & Spalding LLP, Los Angeles, California, for the September 2014 quarterly report and June 2019 quarterly report.

1 All references to a "Section" in this Chapter are to the Internal Revenue Code.

2 42 U.S.C. §4958, Taxpayer Bill of Rights 2 (P.L. 104-168).

3 Report from the Committee on Ways and Means on the Taxpayer Bill of Rights 2, H.R. 2337, March 28, 1996. H. Rep. No. 506, 104th Cong., 2d Sess. (1996) 53.

4 Lawrence M. Brauer and Leonard J. Henzke, Intermediate Sanctions (IRC 4958) Update, 2003 CPE Text at p. E-1, available at http://www.irs.gov/pub/irs-tege/eotopice03.pdf (last accessed June 30, 2014).

Health Care Compliance Professional's Manual, ¶24,405, Overview of Section 4958

Health Care Compliance Professional's Manual ¶24,405

Internal Revenue Code (IRC) Section 4958 imposes excise taxes on each "Excess Benefit Transaction" between a Disqualified Person and an "Applicable Tax-Exempt Organization"[5] (Exempt Organization). Exempt organizations were initially defined as public charities described in IRC Section 501(c)(3) and social welfare organization described in Section 501(c)(4). Section 501(c)(3) public charities include hospitals, medical research organizations, other types of health care providers, and supporting organizations described in IRC Section 509(a)(3) such as parent organizations of health care systems. As part of the Patient Protection and Affordable Care Act,[6] Congress created a new type of tax-exempt organization – qualified nonprofit health insurance issuers – by adding Section 501(c)(29) to the IRC. Congress then added these Section 501(c)(29) organizations to the definition of Applicable Tax-Exempt Organizations. The definition also includes any organization that has been described in any of these Sections within the five years ending on the date of the alleged Excess Benefit Transaction.[7]

The Treasury Regulations further provide that the term Applicable Tax-Exempt Organization does not include quasi-governmental organizations, which are recognized as exempt under IRC Section 115, even if they also are recognized as exempt under IRC Section 501(c)(3) (including, for example, certain county and municipal hospitals) and private foundations.

A "Disqualified Person" for purposes of Section 4958 is any person in a position to exercise substantial influence over the affairs of an Exempt Organization at any point during the five years before the date of the transaction in question, family members of such persons, and any entity in which such a person and his or her family members hold more than a 35-percent interest.[8] An Excess Benefit Transaction includes any transaction in which an economic benefit is provided by an 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 (including the performance of services) received by the Exempt Organization in exchange for providing such benefit. The taxable "Excess Benefit" is equal to the excess of the value of the economic benefit provided to the Disqualified Person over the value of the consideration received by the Exempt Organization.

A Disqualified Person who receives an Excess Benefit incurs an initial excise tax equal to 25 percent of the Excess Benefit (the Initial Tax on Disqualified Persons).[9] If the Excess Benefit is not "corrected" in a timely manner, then the Disqualified Person faces an additional excise tax equal to 200 percent of the Excess Benefit.[10] To "correct" the Excess Benefit, the Disqualified Person must undo the transaction to the extent possible by returning the amount of the Excess Benefit, paying the Exempt Organization interest on the amount of the Excess Benefit from the date of the transaction until the date of correction, and taking any additional measures necessary to place the Exempt Organization in a financial position not worse than it would have been had the Disqualified Person been dealing under the highest fiduciary standards. Disqualified Persons have significant incentive to unwind transactions before allowing the Internal Revenue Service (IRS) to take any enforcement action.

Additionally, any officer, director, trustee or individual having similar powers or responsibilities (each an "Organization Manager") who knowingly and willfully participates in the Excess Benefit Transaction also may be liable for an additional excise tax of 10 percent of the Excess Benefit (up to a maximum of $20,000 per Excess Benefit Transaction) (the Tax on Organization Managers). All Organization Managers participating in the Excess Benefit Transaction are jointly and severally liable for the tax.

Importantly, Section 4958 also includes provisions that allow Exempt Organizations to take appropriate steps to mitigate the risk that transactions entered into with Disqualified Persons may be considered an Excess Benefit Transaction. Taking these measures should help establish that an Organization Manager did not "knowingly and willfully" participate in the arrangement, which would avoid excise tax liability for the Organization Manager.

Footnotes

5 This chapter will usually refer to an Applicable Tax-Exempt Organization simply as an "Exempt Organization."
6 Section 1322(h)(1) of the Patient Protection and Affordable Care Act (P.L. 111-148), March 23, 2010.
7 42 U.S.C. §4958(e).
8 For more information on the tests used to identify Disqualified Persons, see ¶24,445.
9 Also sometimes referred to as the "First-Tier Tax."
10 Also sometimes referred to as the "Second-Tier Tax."

Health Care Compliance Professional's Manual, ¶24,410, Excess Benefit Transactions

Health Care Compliance Professional's Manual ¶24,410

Internal Revenue Code (IRC) Section 4958(c) generally defines an Excess Benefit Transaction as any non-fair market value transaction entered into (directly or indirectly) between an Exempt Organization and a Disqualified Person. For example, an Excess Benefit Transaction would occur if an Exempt Organization paid compensation to its president that exceeded the fair market value of his or her services. Similarly, an Exempt Organization would participate in an Excess Benefit Transaction if it paid more than fair market value for property owned by one of its directors. Special rules expand the definition of an Excess Benefit Transaction beyond non-fair market value transactions for those Exempt Organizations that are donor-advised funds described in IRC Section 4966(d)(2) and supporting organizations described in IRC Section 509(a)(3).

In addition to direct benefits, an Excess Benefit Transaction can occur indirectly using one or more entities controlled by or affiliated with an Exempt Organization. Control means ownership of more than 50 percent of the ownership interest of the entity.[11]

An Excess Benefit Transaction occurs indirectly through a third party intermediary when: (i) the Exempt Organization provides an economic benefit to the intermediary; (ii) the intermediary provides economic benefits to a Disqualified Person of the Exempt Organization; and (iii) either there is evidence of an oral or written agreement or understanding that the intermediary will transfer property to such Disqualified Person, or the intermediary lacks a significant business purpose or exempt purpose of its own for engaging in such a transfer.

In the case of multiple organizations affiliated by common control or governing documents, the determination as to whether a person has substantial influence must be made separately for each organization.

The IRS considers all benefits exchanged between a Disqualified Person and the Exempt Organization, its controlled entities, and its intermediaries in determining whether an Excess Benefit Transaction exists. Thus, Exempt Organizations must consider how their for-profit subsidiaries and joint venture companies affect Excess Benefit Transaction analysis.

Supporting Organizations and Donor Advised Funds

IRC Section 4958 expands the definition of Excess Benefit Transactions for supporting organizations described in IRC Section 509(a)(3) (Supporting Organizations) and donor advised funds described in IRC Section 4966(d) (2) (Donor Advised Funds). In 2005, Congress became concerned that donors used Supporting Organizations and Donor Advised Funds primarily for personal tax planning purposes, with what Sen. Charles Grassley described as a "thimbleful of benefit to charity."[12]

As part of the Pension Protection Act of 2006,[13] Congress amended Section 4958 to treat the following transactions involving Supporting Organizations as per se Excess Benefit Transactions:

- any loan by the Supporting Organization to a Disqualified Person; and
- any grant, loan, compensation or similar payment by a Supporting Organization to a substantial contributor, his or her family members or an entity in which the substantial contributor and his or her family members own more than 35 percent of the combined voting power, profits interest or other beneficial interest.[14]

For these purposes, a "substantial contributor" includes any person who contributed more than $5,000 to the Supporting Organization, if the contributions that the person made exceeded 2 percent of the Supporting Organization's total contributions during the tax year.[15]

Similarly, with respect to any Donor Advised Fund, Excess Benefit Transactions include any grant, loan, compensation or other similar payment by the Donor Advised Fund to a fund manager, his or her family members or any entity in which the fund manager and his or her family members own more than 35 percent of the combined voting power, profits interest or other beneficial interest.[16]

Initial Contract Exception

Section 4958 does not apply to any fixed payment made to a person pursuant to an initial contract regardless of whether the payment might otherwise constitute an Excess Benefit Transaction. An initial contract is a binding written contract between an Exempt Organization and a person who was not a Disqualified Person immediately prior to entering into the contract. There are no limits on the duration of the contract. A fixed payment is an amount of cash or other property specified in the contract, or determined by a fixed formula that is specified in the contract, which is to be paid or transferred in exchange for the provision of specified services or property. In general, a fixed formula may incorporate an amount that depends upon future specified events or contingencies as long as no one has discretion when calculating the amount of a payment or deciding whether to make a payment (such as a bonus). The initial contract exception does not apply if the contract is materially modified or if a person fails to substantially perform his or her obligations under the contract. While the initial contract exception may block the application of Section 4958, it does not alter the substantive rules governing tax exemption, including the prohibition against private inurement. Accordingly, a transaction that is not subject to Section 4958 because of

the initial contract exception may still jeopardize the Exempt Organization's tax-exempt status.[17] The initial contract exception does not apply to the special definition of Excess Benefit Transactions involving Supporting Organizations and Donor Advised Funds.[18]

Footnotes

11 Treas. Reg. §53.4958-4(a)(2)(ii)(B).
12 Stephanie Strom, Big Tax Break Often Bypasses Idea of Charity, New York Times, at p. A15, April 25, 2005.
13 The Pension Protection Act of 2006 (P. L. 109-280), 120 Stat. 780.
14 26 U.S.C. §4958(c)(3)(A).
15 26 U.S.C. §4958(c)(3)(C).
16 26 U.S.C. §4958(c)(2)(A)
17 Treas. Reg. §53.4958-8(a) (2014).
18 I.R.M. §7.27.30.6.1.1 (Nov. 17, 2009), available at http://www.irs.gov/irm/part7/irm_07-027-030.html#d0e527 (last accessed May 30, 2014).

Health Care Compliance Professional's Manual, ¶24,420, Valuation Standards

Health Care Compliance Professional's Manual ¶24,420

Internal Revenue Code (IRC) Section 4958 underscores the need for Exempt Organizations to ensure that transactions involving Disqualified Persons contain terms and conditions that are consistent with fair market value. Existing tax-law standards apply in determining fair market value for Section 4958 purposes.[19] For compensation arrangements, fair market value is based on whether the compensation paid by the Exempt Organization for the services that the Disqualified Person provides is reasonable. Transactions that involve the sale or use of property require that the price be consistent with what a willing buyer and willing seller would agree to considering all relevant facts.[20]

Reasonable Compensation for Services

Compensation for services rendered by Disqualified Persons may not exceed what is reasonable, considering all relevant facts and circumstances. Reasonable compensation is defined as the amount that would ordinarily be paid for like services by like enterprises under like circumstances. Generally, the circumstances to be considered are those that exist on the date the contract for services was made.

All items of compensation must be considered when determining reasonable compensation. Thus, reasonable compensation includes all forms of cash and noncash benefits; all forms of deferred compensation; the amount of premiums paid for liability and other insurance, as well as reimbursement for expenses not covered by such insurance; all other benefits regardless of whether included as income for tax purposes (including medical, dental, and pension benefits, but excluding qualified working condition and de minimis fringe benefits); expense reimbursements; foregone interest on loans; and any economic benefits provided through affiliated organizations.

If compensation is deferred and vests in a later year, the income is attributed to the years in which the services were performed. All remuneration is considered regardless whether such amounts are reported on Internal Revenue Service (IRS) Form W-2 or IRS Form 1099.

Excluded Economic Benefits

Treasury Regulations specifically exclude certain economic benefits from the calculation of reasonable compensation.[21] These excluded economic benefits are as follows:

Nontaxable fringe benefits under Code Section 132, including, but not limited to, the following:

i. no additional cost services (e.g., hotel accommodations, telephone service, and air/train transportation);

ii. qualified employee discounts (e.g., discounts on property or services normally provided by the employer);

iii. working condition fringe benefits (e.g., employer-paid business travel and the use of employer-provided vehicles for business purposes);

iv. de minimis fringe benefits (e.g., occasional meals, local transportation provided for overtime work, meals at employer's eating facilities, occasional cocktail parties or picnics, traditional holiday gifts);

v. qualified transportation benefits (e.g., transit passes, parking);

vi. qualified moving expense reimbursement;

vii. employee achievement awards less than $400; and

viii. on-premises athletic facilities.

Economic benefits provided to a volunteer of the organization, if the organization provides that same benefit to members of the general public in exchange for a membership fee of $75 or less per year.

Economic benefits provided to a member of, or donor to, the organization, if (i) non-Disqualified Persons who pay the same membership fee or make the same contribution are entitled to receive substantially the same economic benefit, and (ii) a significant number of non-Disqualified Persons make a payment or donation of at least the same amount as the Disqualified Person.

Economic benefits provided to a charitable beneficiary.

Economic benefits provided to a governmental unit.

Valuation of Property

The fair market value for property transferred is the price at which property (or the right to use property) would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell the property, and both having reasonable knowledge of relevant facts.

Valuation Opinions

Obtaining a valuation opinion from a qualified, independent appraiser can help preserve the tax-exempt status of an Exempt Organization while also providing Disqualified Persons with a defense against excise tax liability under Section 4958. In Caracci v. *Commissioner*,[22] the U.S. Court of Appeals for the Fifth Circuit (Fifth Circuit) reversed a Tax Court's decision imposing over $69 million in excise tax liability under Section 4958 on Disqualified Persons because of an alleged Excess Benefit Transaction involving the conversion of Exempt Organizations to for-profit status.

Caracci involved three Exempt Organizations that members of the Caracci family had established to operate home health agencies in Mississippi. Each of the Exempt Organizations had struggled financially, requiring newly hired employees to defer their first month of pay, underpaying salaries and wages for other employees and deferring contributions to employee benefit plans. The Exempt Organizations served predominantly Medicare beneficiaries. Due to Medicare's reimbursement method for home health agencies during the 1990s, the operating deficit for each Exempt Organization increased with the number of patients that the Exempt Organization served.

To stabilize the Exempt Organizations financially, the Caracci family consulted an attorney with significant home health agency experience, and, after attempts to find a buyer for the Exempt Organizations failed, they decided to follow the attorney's advice by converting each of the Exempt Organizations into privately held, for- profit companies. The Exempt Organizations transferred their assets to corporations that the Caraccis owned in exchange for these corporations assuming the debts and liabilities of the Exempt Organizations. Prior to converting the Exempt Organizations, the Caraccis obtained two appraisals of the Exempt Organizations' assets and liabilities. Both appraisals showed that the liabilities of the Exempt Organizations exceeded the value of their assets. The IRS disputed these valuations and asserted that the exchange was not consistent with fair market value. The IRS sought to revoke each Exempt Organization's tax-exempt status and assess over $250 million in excise taxes under Section 4958.

The IRS had used an internal valuation to determine that the assets of the Exempt Organizations exceeded their liabilities by $18.5 million. The Tax Court disagreed with the valuation that the IRS provided, but it used its own methodology to find that the net excess benefit that the Caraccis received due to the conversion was $5.1 million. The Tax Court then assessed the Initial Tax on Disqualified Persons, the Additional Tax on Disqualified Persons and the Tax on Organization Managers in the amount of $69,702,390. The Fifth Circuit reversed and entered judgment in favor of the Caraccis.

The Fifth Circuit criticized the valuation methodology that the IRS had used in initially assessing excise tax liability. It also found that the Tax Court had erred by developing and applying its own valuation methodology. In making its decision, the Fifth Circuit noted that the Exempt Organizations "took a careful and conscientious approach to the conversion" by obtaining two appraisals. In entering judgment for the Caraccis, the Fifth Circuit stated:

> The Tax Court erred as a matter of law when it failed to find for the taxpayers after it rejected much of the Commissioner's expert's opinion and instead proceeded to use bits and pieces from that opinion to value the [Exempt Organizations'] assets transferred to the newly created nonexempt entities. The Tax Court erred as a matter of law in the valuation method that it selected. In the process of arriving at and applying that method, and in struggling to make that method make sense, the Tax Court made a number of clearly erroneous factual findings. These errors led the Tax Court to reject the taxpayers' expert, whose adjusted balance sheet valuation method provided the only rational and justifiable valuation available in the record ...."[23]

Caracci demonstrates that Exempt Organizations may protect their tax-exempt status and establish a defense for Disqualified Persons against excise tax liability under Section 4958 by obtaining a valuation opinion from a qualified, independent appraiser

prior to entering into a transaction with a Disqualified Person. Merely obtaining an appraisal is not sufficient for Section 4958 purposes. The appraiser must be qualified to render an opinion on the potential Excess Benefit Transaction at issue. In Caracci, for example, the IRS attempted to support its arguments through the work of a valuation expert who had no prior experience in the home-health care industry. The IRS also compared publicly traded companies to the Exempt Organizations without acknowledging that the Exempt Organizations operated in a less favorable market than the publicly traded companies, depended more heavily on Medicare reimbursement than the publicly traded companies, and did not offer additional health care services like the publicly traded companies. Taken together, the inexperience of the IRS's valuation consultant, coupled with errors in his methodology, caused the Fifth Circuit to conclude that neither the IRS nor its consultant had done the work necessary for an asset valuation of the Exempt Organizations.

Footnotes

19 Report from the Committee on Ways and Means on the Taxpayer Bill of Rights 2, H.R. 2337, March 28, 1996. H. Rep. No. 506, 104th Cong., 2d Sess. (1996) at 56.

20 Lawrence M. Brauer, Toussaint T. Tyson, Leonard J. Henzke and Debra J. Kawecki, An Introduction to IRC 4958 (Intermediate Sanctions), 2002 CPE Text, at p. 266.

21 Treas. Reg. §53.4958-(a)(4).

22 Caracci v. Commissioner of Internal Revenue, 2006 WL 1892600 (5th Cir. 2006).

23 Id.

Health Care Compliance Professional's Manual, ¶24,430, Types of Penalty Excise Taxes and Correction Process

Health Care Compliance Professional's Manual ¶24,430

Internal Revenue Code (IRC) Section 4958 imposes potentially three separate taxes on each Excess Benefit Transaction: (i) an Initial Tax on Disqualified Persons; (ii) an Additional Tax on Disqualified Persons; and (iii) a Tax on Organization Managers. If the Disqualified Person who receives the benefit is also an Organization Manager who knowingly approves such transactions, such individuals could be liable for all three taxes.

Initial Tax on Disqualified Persons. A Disqualified Person who receives an excess benefit is liable for payment of an excise tax equal to 25 percent of the Excess Benefit. If more than one Disqualified Person is liable for the tax, all such persons are jointly and severally liable. Pursuant to Section 275 payment of the Initial Tax on Disqualified Persons is nondeductible.

Additional Tax on Disqualified Persons. If the Internal Revenue Service (IRS) imposes the Initial Tax on Disqualified Person and the Disqualified Person fails to correct the Excess Benefit Transaction within the Taxable Period, then the Disqualified Person will incur an additional excise tax of 200 percent of the Excess Benefit. If more than one Disqualified Person is liable for the Additional Tax on Disqualified Persons, all such persons are jointly and severally liable.

Taxable Period. The "Taxable Period" begins on the date of the Excess Benefit Transaction and ends on the earlier of (i) the date of mailing to the Disqualified Person of a statutory notice of deficiency with respect to the Initial Tax or (ii) the date of assessment of the Initial Tax. Under Section 7602(c), the IRS must notify Disqualified Persons that it is examining a potential Excess Benefit Transaction before the end of the Taxable Period.

Tax on Organization Managers. An Organization Manager who participates in the Excess Benefit Transaction, knowing that it was such a transaction, incurs excise tax liability equal to 10 percent of the Excess Benefit up to $20,000 per transaction, unless participation was not willful and was due to reasonable cause.

Correction of an Excess Benefit Transaction

A Disqualified Person faces the Additional Tax on Disqualified Persons when the IRS has imposed Initial Tax on an Excess Benefit Transaction that has not been corrected within the Taxable Period. The term "Correction" means the undoing of the Excess Benefit Transaction to the extent possible and taking any additional measures necessary to place the Exempt Organization in a financial position not worse than that in which it would have been had the Disqualified Person been dealing under the highest fiduciary standards.

IRC Section 4958 defines the correction amount as the sum of: (i) the Excess Benefit; plus (ii) the amount of interest calculated on the Excess Benefit from the date of the transaction to the date of correction. The interest rate used for this purpose must equal at least the applicable federal rate, compounded annually, for the month in which the transaction occurred. If the Disqualified Person makes a payment of less than the full Correction amount, the IRS may impose the Additional Tax on the unpaid portion of the Correction amount.

In certain circumstances, subject to the approval of the Exempt Organization, a Disqualified Person may correct an Excess Benefit Transaction by returning the property to the Exempt Organization and taking any other additional steps necessary to make the Exempt Organization whole. If the Excess Benefit was paid pursuant to a personal services agreement (e.g., employment agreement or independent contractor agreement) that has not been completed, then termination of the agreement is not required for correction to occur. The terms of any ongoing arrangement may need to be modified, however, to avoid future Excess Benefit Transactions.

Health Care Compliance Professional's Manual, ¶24,440, Tests to Determine Disqualified Persons

Health Care Compliance Professional's Manual ¶24,440

Internal Revenue Code (IRC) Section 4958(f)(1) defines the term Disqualified Person to mean, with respect to any transaction, (i) any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization, (ii) a family member of such individual, or (iii) a 35-percent controlled entity (i.e., a corporation, partnership, or trust or estate in which the persons described in (i) and (ii) own more than a 35-percent interest).

The regulations set forth two "per se" tests and one "facts and circumstances" test for determining whether an individual or entity is a Disqualified Person. The regulations also explicitly exclude specific categories of organizations and people from the definition of a Disqualified Person.

Per Se Test No. 1—Persons Deemed to Have Substantial Influence Because of Powers[24]

Persons who hold the following powers or positions within an Exempt Organization are deemed to have substantial influence over that Exempt Organization:

- any individual serving on the governing body of the organization who is entitled to vote on any matter over which the governing body has authority;
- presidents, chief executive officers, or chief operating officers (and any person or entity who, regardless of title, has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization);
- treasurers and chief financial officers (and any person who, regardless of title, has ultimate responsibility for managing the finances of the organization); and Persons with a material financial interest in a "provider-sponsored organization."[25]

A for-profit management company of a hospital is a Disqualified Person with respect to the hospital because ultimately the management company is responsible for supervising the management of the hospital, consistent with the description of the responsibilities of a president, chief executive officer, or chief operating officer.

Per Se Test No. 2—Persons Related to Disqualified Persons

Persons in the following relationships to Disqualified Persons are themselves deemed to be Disqualified

Persons:[26]

- family members, including spouses, brothers or sisters (by whole or half blood), spouses of brothers or sisters (by whole or half blood), ancestors, children, grandchildren, great-grandchildren, and spouses of children, grandchildren, and great-grandchildren; and
- controlled entities, including corporations in which Disqualified Persons own more than 35 percent of the combined voting power, a partnership in which Disqualified Persons own more than 35 percent of the profits' interest, or a trust or estate in which Disqualified Persons own more than 35 percent of the beneficial interest.

Facts and Circumstances Test[27]

If a person is not automatically treated as a Disqualified Person under Per Se Test No. 1 or No. 2, then a facts and circumstances test applies.

(a) **Facts and Circumstances Showing Influence**

According to the Treasury Regulations, the following circumstances tend to indicate that a person does have substantial influence over the affairs of an Exempt Organization:

- the person is the founder of the Exempt Organization;
- the person is a substantial contributor to the Exempt Organization;
- the person's compensation is primarily based on revenues derived from activities of the Exempt Organization or of a particular department or function of the Exempt Organization that the person controls;
- the person has or shares authority to control or determine a substantial portion of the Exempt Organization's capital expenditures, operating budget, or compensation for employees;

- the person manages a discrete segment or activity of the Exempt Organization that represents a substantial portion of the Exempt Organization;
- the person owns a controlling interest in a corporation, partnership, or trust that is a Disqualified Person; and/or
- the person is a nonstock Exempt Organization controlled by one or more Disqualified Persons.

(b) **Facts and Circumstances Showing Lack of Influence**

By contrast, the Treasury Regulations indicate that the following circumstances tend to indicate that a person does not have substantial influence over the affairs of the Exempt Organization:

- the person has taken a bona fide vow of poverty as an employee or agent on behalf of a religious organization;
- the person is an attorney, accountant, investment manager, or like advisor whose role with the Exempt Organization is limited to providing professional advice (without having decision-making authority) with respect to transactions from which the person will not economically benefit (aside from customary fees received for the professional advice rendered);
- the direct supervisor of the individual is not a Disqualified Person;
- the person does not participate in any management decisions affecting the Exempt Organization as a whole or a discrete segment or activity of the Exempt Organization that represents a substantial portion of the activities, assets, income, or expenses of the Exempt Organization, as compared to the Exempt Organization as a whole; and/or
- any preferential treatment a person receives based on the size of the person's contribution is also offered to all other donors making a comparable contribution as part of the solicitation intended to attract a substantial number of contributions.

(c) **Application of Facts and Circumstances Test**

In 2013, the Internal Revenue Service (IRS) applied the facts and circumstances test to determine that a highly compensated physician was not a Disqualified Person with respect to an Exempt Organization that operated a hospital ("Hospital") or its affiliated practice group ("Practice Group").[28] According to the Private Letter Ruling, the Hospital operated the only around-the-clock emergency room within a 200-mile radius, and it had difficulty maintaining adequate physician coverage for the emergency room. The Hospital had diverted emergency patients to other facilities due to a lack of coverage. Eventually, the Hospital addressed its coverage problem by recruiting a physician ("Doctor") to be a full-time employee of the Practice Group.

The Doctor's employment agreement contained a hybrid compensation model that included a fixed salary plus compensation based on the work Relative Value Units (wRVUs) that the Doctor personally performed. According to the Private Letter Ruling, the Doctor was extremely productive, and his practice represented approximately 6.6 and 4.3 percent of the patient service revenues of the Practice Group and the Hospital, respectively. Even so, the Private Letter Ruling said the Doctor's services resulted in a net loss for the Practice Group and the Hospital. The Doctor was the highest compensated employee of the Practice Group, earning twice as much as the next highest paid

employee. The Doctor took a leave of absence from his duties, but, after an extension of his leave, the Doctor did not return. The Practice Group then terminated the Doctor's employment. The Physician Group had continued to pay the Doctor pursuant to his employment agreement through the date of his termination.

The IRS examined the criteria set forth in the Treasury Regulations, and it determined that none of the factors showing substantial influence existed. The IRS reasoned as follows:

> In the case at hand, Doctor never served as a department head of any of [the Practice Group's] affiliates and did not have any business relationships with current or former officers or board members of [the Practice Group or the Hospital] outside of his employment by [the Practice Group]. As a result, Doctor was never in a position to exercise substantial influence over the affairs of Hospital or [Practice Group]. The gross revenues of [the Practice Group] and Hospital represented by Doctor's practice were approximately 6.6% and 4.3% of total patient services revenue ...., [but] his services resulted in a combined net loss .... This indicates that Doctor was not a disqualified person....

The Private Letter Ruling indicates that generating significant revenue alone will not turn a physician into a Disqualified Person. Instead, the IRS will look for the control that a physician might have as a department head, other business dealings that he or she might have with an Exempt Organization, its officers and directors, and whether the physician produces a profit for the Exempt Organization.

Non-Disqualified Persons[29]

Finally, the following types of persons are deemed not to have substantial influence over an Exempt

Organization, even if they otherwise satisfy the facts and circumstances test:

- IRC Section 501(c)(3) organizations;
- IRC Section 501(c)(4) organizations (but only with respect to another Code Section 501(c)(4) organizations); and/or
- Certain employees of the Exempt Organization who receive economic benefits, directly or indirectly from the Exempt Organization, of less than the defined annual amount ($115,000 as of 2014)[30] if (i) the person is not automatically deemed a Disqualified Person by virtue of the per se tests, and (ii) the person is not a substantial contributor to the Exempt Organization.

Employed physicians and other medical staff members may not be Disqualified Persons if they are not board members, officers, or otherwise in a position to exercise substantial influence over the Exempt Organization. Likewise, "physician recruitment" agreements would likely not be Excess Benefit Transactions pursuant to the "initial contract exception" because such physicians are generally new to the community and are not Disqualified Persons with respect to the hospital immediately prior to entering into the contract. Similarly, "medical director" agreements should not give rise to Excess Benefit Transaction concerns if the physician is an independent contractor and is not otherwise in a position to exercise significant influence over the Exempt Organization (e.g., the medical director also is not a board member, officer, or substantial contributor).

Footnotes

24 Treasury Reg. §53.4958-3(c).
25 As defined in §185(e) of the Social Security Act, 42 U.S.C. §1395w-25.
26 Treasury Reg. §53.4958-3(b).
27 Treasury Reg. §53.4958-3(e).
28 Priv. Ltr. Rul. 201336020, Sept. 6, 2013.
29 Treasury Reg. §53.4958-3(d).
30 The dollar amount of nonhighly compensated employees changes annually (IRC Section 414(q)(1)(B)(I)).

Health Care Compliance Professional's Manual, ¶24,445, Organization Managers

Health Care Compliance Professional's Manual ¶24,445

The term Organization Manager means, with respect to any Exempt Organization, any officer, director, or trustee of such Exempt Organization (or any individual having similar powers or responsibilities). A person is considered an Organization Manager if (i) the person is specifically designated as such in the Exempt Organization's governing documents, or (ii) the person regularly exercises general authority to make administrative or policy decisions on behalf of the Exempt Organization. A person who is not an officer, director, or trustee, but who sits on a committee of the board that invokes the rebuttable presumption, is deemed to be an Organization Manager for purposes of the Tax on Organization Managers. Any person who has authority merely to recommend a particular decision but not to implement it without the approval of a superior, however, is not an officer. For example, independent contractors, such as attorneys, accountants, and investment managers and advisers, are not officers.

Knowing Participation

The tax on Organization Managers will be assessed on an Organization Manager who knowingly participates in an Excess Benefit Transaction, unless such participation was not willful and is due to reasonable cause. The term "knowingly" means a person (i) has actual knowledge of sufficient facts so that, based solely on those facts, such transaction would be an Excess Benefit Transaction; (ii) is aware that such an act under such circumstances may violate the provisions of federal tax laws governing Excess Benefit Transactions; and (iii) negligently fails to make reasonable attempts to ascertain whether the transaction is an Excess Benefit Transaction, or the person is aware that it is such a transaction. While "knowingly" does not mean having reason to know, evidence that a person had reason to know of a particular fact or rule is relevant in determining whether the person had actual knowledge of such fact or rule. Also, an Organization Manager will not be considered to have participated when he or she has opposed the transaction in a manner consistent with the fulfillment of his or her responsibilities to the Exempt Organization. An Organization Manager's participation in a transaction is ordinarily not considered knowing if the organization satisfied the rebuttable presumption of reasonableness, regardless of whether the Organization Manager relied upon such fact.

An act of an Organization Manager is willful if it is voluntary, conscious, and intentional. No motive to avoid the law or the incurrence of any tax is necessary to make participation willful. Participation includes silence or inaction on the part of the Organization Manager when the person is under a duty to speak or act, as well as any affirmative action by such person. Participation is not willful if the Organization Manager does not know that the transaction is an Excess Benefit Transaction.

Safe Harbors and Exceptions

An Organization Manager's participation will be considered due to reasonable cause if the person has exercised his or her responsibility with ordinary business care and prudence. A good way to establish reasonable cause is to obtain professional advice. An Organization Manager's participation in a transaction will ordinarily not be considered knowing to the extent that, after full disclosure of the facts to an appropriate professional, the Organization Manager relies upon a reasoned written opinion with respect to the elements of the transaction within the professional's expertise. A reasoned opinion is one that addresses itself to the facts and the applicable standards. An opinion is not reasoned if it does nothing more than recite the facts and then express a conclusion. The term "appropriate professional" means the following: (i) legal counsel (including in-house counsel), (ii) certified public accountants or accounting firms with relevant expertise, and (iii) independent compensation/valuation experts who meet specified requirements. The fact that an opinion is not obtained, however, does not alone create the inference that an Organization Manager's participation was knowing, willful, and without reasonable cause.

Health Care Compliance Professional's Manual, ¶24,450, Establishing the Rebuttable Presumption

Health Care Compliance Professional's Manual ¶24,450

One of the most important aspects of Internal Revenue Code (IRC) Section 4958 is a procedure contained in the Treasury Regulations that allows Exempt Organizations to establish a Rebuttable Presumption that transactions with Disqualified Persons are reasonable. Establishing the Rebuttable Presumption shifts the burden of proof to the Internal Revenue Service (IRS) on issues of fair market value, provides a safe harbor to Organization Managers from the Tax on Organization Managers, and would be a factor considered by the IRS

when considering whether the facts and circumstances also warrant revocation of the Exempt Organization's tax- exempt status. The fact that no Rebuttable Presumption exists in connection with a particular transaction does not create the inference that the transaction is an Excess Benefit Transaction.

To establish the Rebuttable Presumption, an Exempt Organization must complete the following three steps before the first payment (or sale/transfer of property) to a Disqualified Person: approval of an authorized body, reliance upon appropriate comparability data, and contemporaneous documentation.

Approval of an Authorized Body

The terms of the transaction must be approved in advance by an "Authorized Body" of the Exempt Organization that is composed entirely of individuals who do not have a conflict of interest with respect to the transaction. An Authorized Body includes the Exempt Organization's Board of Directors or an authorized committee of the board (to the extent that such a committee is permitted by state law to act on behalf of the board).

All members of the board or committee must be independent (i.e., without a conflict of interest) and not subject to the control of the Disqualified Person involved in the transaction. Adoption of the Internal Revenue Service model Conflicts of Interest policy alone is not sufficient. An individual is not considered to be included on the

Authorized Body when it is reviewing a transaction if that individual meets with other members of the Authorized Body only to answer questions, and otherwise recuses him or herself from the meeting and is not present during debate and voting on the transaction.

Appropriate Comparability Data

The Authorized Body must obtain and rely upon appropriate comparability data to determine the proper level of compensation. The Exempt Organization is permitted to compile its own comparability data.

In the case of compensation arrangements, relevant information includes compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the organization; current compensation surveys compiled by independent firms (these sources of comparability data usually come from either a consulting firm specializing in compensation or published compensation surveys from organizations); and actual written offers from similar institutions competing for the services of the disqualified person.

In the case of property, relevant information includes, but is not limited to, current independent appraisals of the value of all property to be transferred and offers received as part of an open and competitive bidding process.

In the case of compensation paid by a "small organization" (i.e., one with annual gross receipts of less than $1 million based on a three-year rolling average), the appropriate data will be met if the governing body has data on compensation paid by three comparable organizations in the same or similar communities for similar services.

Contemporaneous Documentation

The Authorized Body must adequately and timely document the reasons for the determination concurrently with making the determination.

The written records of the Exempt Organization (e.g., board minutes in corporate minute books) must contain the following: (i) the material terms of the transaction and the date it was approved; (ii) the members of the Authorized Body who were present during deliberation and those who voted on the arrangement; (iii) the comparability data obtained and relied upon by the Authorized Body and how the data was obtained; and (iv) the actions taken by the person on the Authorized Body who had a conflict of interest, if any (e.g., left the room during deliberation and/or abstained from voting).

If the Authorized Body determines reasonable compensation for a specific arrangement is higher or lower than the range of comparable data obtained, the Authorized Body must record the basis for its determination.

For documentation of the decision to be contemporaneous, the Treasury Regulations provide that the meeting minutes must be prepared and distributed by the latter of (i) the next meeting of the Authorized Body, or (ii) 60 days after the final action or actions of the Authorized Body are taken. Records must then be reviewed and approved by the Authorized Body as reasonable, accurate, and complete within a reasonable time period thereafter.

Compensation survey material that does not take into account the size of the organization, the region of the country in which the organization is located, and the particular area of specialty may be insufficient to qualify as appropriate data.

Checklists

The IRS published two checklists as part of its 2002 Continuing Professional Educational Technical Instruction Program to help IRS agents evaluate whether an Exempt Organization has established the Rebuttable Presumption. One checklist addresses compensation paid to Disqualified Persons and the other addresses property provided. These checklists are beneficial for Exempt Organizations because they provide guidance on what the IRS considers when evaluating reasonable compensation. These checklists are included in this chapter in Appendices A (¶24,485) and B (¶24,490), respectively.

Health Care Compliance Professional's Manual, ¶24,455, Automatic Excess Benefit Transaction

Health Care Compliance Professional's Manual ¶24,455

An economic benefit is not treated as consideration for the performance of services unless the Exempt Organization providing the benefit clearly indicates its intent to treat the benefit as compensation when the benefit is paid. If an Exempt Organization provides an economic benefit to a Disqualified Person without clearly indicating its intent to treat the benefit as compensation for services, then the benefit automatically will be presumed to be an Excess Benefit Transaction under Internal Revenue Code (IRC) Section 4958, even if the total compensation paid to such person is otherwise reasonable.

An Exempt Organization (or entity that it controls) is treated as clearly indicating its intent to provide an economic benefit as compensation for services only if the Exempt Organization provides written substantiation that is contemporaneous with the transfer of the economic benefits under consideration. Ways to provide contemporaneous written substantiation of its intent to provide an economic benefit as compensation include: (i) the Exempt Organization produces a signed written employment agreement, (ii) the Exempt Organization reports the benefits as compensation on an original Form W-2, Form 1099 or Form 990, or on an amended form filed prior to the start of an IRS examination, (iii) the Disqualified Person reports the benefit as income on the person's original Form 1040 or on an amended return filed prior to the start of an IRS examination.[31] To the extent the economic benefit is excluded from the Disqualified Person's gross income for income tax purposes, the Exempt Organization is not required to indicate its intent to provide an economic benefit as compensation for services (e.g., employer-provided health benefits and contributions to qualified plans under IRC Section 401(a)).

Footnotes

31 See, e.g. Priv. Ltr. Rul. 201740022 (Oct. 10, 2017) (discussing, among other items, the potential for automatic excess benefit transactions of potentially reasonable payments to a disqualified person in excess of stated compensation but for which no Form W-2, Form 1099 or Form 1040 were provided).

Health Care Compliance Professional's Manual, ¶24,460, Reporting Obligations

Health Care Compliance Professional's Manual ¶24,460

If an Excess Benefit Transaction exists, then the Disqualified Persons and, if applicable, Organization Managers must assess and report the excise taxes imposed by Internal Revenue Code (IRC) Section 4958 using Form 4720.[32] The form is due on or before the fifteenth day of the fifth month following the close of such person's taxable year, which would be May 15 for a calendar year taxpayer.

An Exempt Organization completing Form 990 must report any Excess Benefit Transactions entered into or discovered during the reporting year. For example, Part IV, Line 25a asks whether the Exempt Organization participated in an Excess Benefit Transaction during the tax year, and Part IV, Line 26b requires the Exempt Organization to disclose whether it became aware of any unreported Excess Benefit Transactions that occurred during prior years. Exempt Organizations that disclose the existence of an Excess Benefit Transaction must then complete Schedule L to the Form 990. Schedule L requires the Exempt Organization identify the Disqualified Person(s) involved, describe the Excess Benefit Transaction, indicate whether the Excess Benefit Transaction was corrected, report the amount of tax imposed on Disqualified Persons, and report the portion of such taxes paid by the Exempt Organization. An indemnification agreement whereby an Exempt Organization is required to pay or reimburse a Disqualified Person's excise taxes could give rise to additional Excess Benefit Transactions and more excise taxes.

Because the excise taxes applicable to Excess Benefit Transactions are of a self-reporting nature, the penalties for failure to file or signing or assisting in the preparation of a false or fraudulent return apply. There is no statute of limitations (SOL) when a false or fraudulent Form 990 is filed or a willful attempt to evade the excise tax exists. The SOL is limited to three years from the date of disclosure if the tax-exempt organization sufficiently disclosed, but is increased to six years if there is not sufficient disclosure but no fraud intended.

Nature of Tax Penalty	Penalty Amount
Failure to File Form 4720	5% of the §4958 excise tax owed up to 25% of the total amount owed. The penalty increases to up to 75% of the total amount owed if the failure to file is fraudulent. The penalty is excused if failure to file is due to reasonable cause and not willful neglect.
Failure to Pay §4958 Excise Tax	0.5% of the §4958 excise tax owed up to 25% of the total amount owed.
Form 990 Accuracy-Related Penalties	Exempt organizations having less than $1,000,000 in gross receipts incur a penalty of $20 per day up to the lesser of $10,000 or 5% of the organization's gross receipts. Exempt Organizations with gross receipts of $1,000,000 or more can be assessed a penalty of $100 per day up to a maximum of $50,000.

Footnotes
32 Treasury Reg. §53.6071-1(f)(1).

Health Care Compliance Professional's Manual, ¶24,465, Revocation of Tax-Exempt Status

Health Care Compliance Professional's Manual ¶24,465

Congress recognized that imposing excise tax penalties under Section 4958 would not necessarily prevent the Internal Revenue Service (IRS) from revoking the tax-exempt status of an Exempt Organization involved in an Excess Benefit Transaction. The House Report on Internal Revenue Code (IRC) Section 4958 noted the broad authority of the IRS to police Exempt Organizations by saying that "intermediate sanctions for excess benefit transactions may be imposed by the IRS in lieu of (or in addition to) revocation of the organization's tax-exempt status."[33] Uncertainty surrounded the point at which the IRS would seek to revoke the tax-exempt status of an Exempt Organization that engaged in one or more Excess Benefit Transactions as opposed to merely assessing liability for the excise tax. The IRS did not establish a bright line test for making this determination. Instead, the IRS issued Treasury Regulations identifying the factors that it would consider in determining whether to revoke the tax-exempt status of an Exempt Organization involved in an Excess Benefit Transaction.[34]

Facts and Circumstances Test

The IRS will apply a facts and circumstances test to determine whether to revoke tax-exempt status (in addition to imposing excise taxes under IRC Section 4958 for Exempt Organizations that have engaged in one or more Excess Benefit Transactions. Among other things, the IRS will consider the following factors:

- **Factor 1** - The size and scope of the Exempt Organization's regular and ongoing activities that further exempt purposes before and after the Excess Benefit Transaction or Transactions occurred.
- **Factor 2** – The size and scope of the Excess Benefit Transaction or Transactions (collectively, if more than one) in relation to the size and scope of the Exempt Organization's regular and ongoing activities that further tax-exempt purposes.
- **Factor 3** – Whether the Exempt Organization has been involved in multiple Excess Benefit Transactions with one or more persons.
- **Factor 4** – Whether the Exempt Organization has implemented safeguards that are reasonably calculated to prevent future Excess Benefit Transactions.
- **Factor 5** – Whether the Excess Benefit Transaction has been corrected, or the Exempt Organization has made a good faith effort to seek correction from the Disqualified Persons who benefited from the Excess Benefit Transaction.[35]

Weighing the Factors

The Internal Revenue Service (IRS) will consider all factors in combination. The weight that the IRS assigns to each Factor, however, will depend on the particular situation. For example, the regulations state that Factors (4) and (5) will weigh more strongly in favor of continuing the Exempt Organization's tax-exempt status if the Exempt Organization discovers the Excess Benefit Transactions and takes corrective action before the IRS discovers it.[36] In addition, simply correcting the Excess Benefit Transaction after the IRS discovers it will not be by itself a sufficient basis for maintaining tax exemption.

Footnotes

33 H. Rep. No. 104-506, 104th Cong., 2d Sess., at 59 (1996).
34 Final regulations, 73 FR 16519, March 28, 2008.
35 Treas. Reg. §1.501(c)(3)-1(f)(2)(ii).
36 Treas. Reg. §1.501(c)(3)-1(f)(2)(iii).

Health Care Compliance Professional's Manual, ¶24,470, Examples of Facts and Circumstances Test for Tax-Exempt Status

Health Care Compliance Professional's Manual ¶24,470

The Internal Revenue Service (IRS) offered six examples as part of the Treasury Regulations to illustrate how it would apply the facts and circumstances test (see ¶24,465).[37] Five of the examples address fairly clear-cut situations in which the Excess Benefit either is overwhelming and continuous or de *minimis* and isolated. The sixth example, however, offers a more nuanced view of how the IRS will apply the test when an Exempt Organization participates in an Excess Benefit Transaction that it cannot fully correct.

In Example 6, an Exempt Organization had adopted written procedures for setting executive compensation that were designed to trigger the rebuttable presumption of reasonableness. The Exempt Organization's board of directors approved compensation packages for its top executives based on a salary range that its compensation committee had established. In setting this range, however, the compensation committee relied on compensation paid by organizations with greater annual revenue that served larger, more diverse populations. As a result, the IRS determined that the Exempt Organization had relied upon inappropriate compensation data and had participated in Excess Benefit Transactions by paying excessive compensation to its top executives.

In response to this finding, the Exempt Organization added members to its compensation committee who had greater expertise in compensation matters, and the Exempt Organization amended its procedures to require the compensation committee to evaluate a number of factors in assessing the comparability of compensation data, including the size, geographic area, and population covered by the Exempt Organization. The Exempt Organization also renegotiated the contracts of its executives in accordance with the new procedures on a going forward basis. To avoid liability under state contract law, the Exempt Organization did not attempt to recover any excess compensation that it had paid to the executives.

The IRS concluded that the Exempt Organization in Example 6 could retain its tax-exempt status. It reasoned, "The fact that O amended its written procedures to ensure the use of appropriate comparability data and renegotiated the top executives' compensation packages on a going-forward basis are also factors favoring continued exemption, even though [the Exempt Organization] did not void the top executives' existing contracts and did not seek correction from the top executives."[38] Example 6 suggests that the IRS will weigh the factors reasonably, considering external factors that may prevent an Exempt Organization from correcting an Excess Benefit Transaction fully, such as potential liability under state law.

Taken together, the examples illustrate that the IRS is likely to look more favorably upon the following facts and circumstances: (i) the Exempt Organization conducts an internal audit and discovers the Excess Benefit Transaction(s) before the IRS; (ii) the Excess Benefit Transaction was a one-time occurrence; (iii) upon discovery of the

occurrence of the Excess Benefit Transaction, the Exempt Organization severs all ties with the Disqualified Person and adopts a conflicts-of-interest policy and other safeguards to prevent future occurrences; and (iv) the Exempt Organization makes a good faith effort to correct the Excess Benefit Transaction by recovering the amount of the excess benefit paid to the Disqualified Person.

The IRS illustrated the application of the Factors when revoking the charitable status of an alcohol and drug counseling organization.[39] The organization failed to establish that a myriad of debit card purchases, checks, withdrawals and other payments furthered its charitable purposes and were not excess benefit transactions in the form of personal payments to, or on behalf, of its chief executive officer. The IRS evaluated each of the Factors to determine whether the excess benefit transactions amounted to private inurement, justifiying the revocation of the organization's charitable status. The IRS found no factors weighed in the organization's favor, and it justified revoking the organization's charitable status because, among other things, the size and scope of the excess benefit transactions was substantial in comparison to the organization's charitable activities, the organization had adopted no discernable safeguards that would have prevented the chief executive officer from using the organization's bank accounts as his own, and the organization had not undertaken any efforts to correct these transactions.[40]

Footnotes

37 Treas. Reg. §1.501(c)(3)-1(f)(2)(iv).
38 Treas. Reg. §1.501(c)(3)-1(f)(2)(iv) (Example 6).
39 Priv. Letter Rul. 201816012 (April 20, 2018).
40 Id.

Health Care Compliance Professional's Manual, ¶24,475, Executive Compensation under Tax Cut and Jobs Act

Health Care Compliance Professional's Manual ¶24,475

Congress overhauled the Internal Revenue Code for the first time in 31 years when it passed federal tax reform in 2017.[41] The Tax Cut and Jobs Act responded to concerns that charitable organizations paid executives excessively through the adoption of a tax on excess executive compensation.[42] For tax years beginning after December 31, 2017, charitable hospitals and other nonprofit organizations face a 21 percent excise tax on the amount in excess of $1 million that they, together with any related organizations, pay to each of their five highest paid employees.[43] The excise tax also applies to certain parachute payments that may arise at an employee's retirement or severance.[44] The IRS recognized the potential overlap between Section 4958 and the new executive compensation excise tax in guidance interpreting the new law.[45] Significantly, the IRS stated that paying the executive compensation excise tax is not determinative as to whether the remuneration paid to a covered employee is excessive for purposes of Section 4958.[46] The IRS also emphasized that charitable organizations cannot assume that a compensation arrangement complies with Section 4958 just because the arrangement is not subject to the executive compensation excise tax. In other words, charitable organizations must apply the executive compensation excise tax and Section 4958 separately to each compensation arrangement.

Footnotes

41 Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for the Fiscal Year 2018, Pub. L. 115-97 (the "Tax Cut and Jobs Act").
42 26 U.S.C. §4960 (2019).
43 26 U.S.C. §4960(a).
44 26 U.S.C. §4960(c)(5).
45 See, e.g., IRS Notice 2019-9 (Dec. 31, 2018), at Q-36.
46 Id.

Health Care Compliance Professional's Manual, ¶24,480, Conclusion

Health Care Compliance Professional's Manual ¶24,480

Internal Revenue Code Section 4958 creates a framework for policing Excess Benefit Transactions that even representatives of the Internal Revenue Service (IRS) admit make it "easy for an agent to set up a deficiency."[47] Exempt Organizations can help avoid these deficiencies by using this Chapter to develop and implement good corporate governance practices. The IRS has often expressed its belief that Exempt Organizations who employ good governance practices are more likely to comply with Section 4958 and other federal tax laws. Sara Hall Ingram, the former Commissioner for Tax Exempt and Government Entities, said, "Where an organization has adopted good governance practices, [the IRS] can reasonably expect that it poses less of a risk that it will misuse its tax-exempt status or its charitable assets than an organization that has not adopted such principles."[48]

In the context of Section 4958, good governance practices mean adopting and enforcing policies and procedures that:

- identify potential Disqualified Persons;
- document all compensation and benefits provided to Disqualified Persons;
- ensure that the terms of transactions with Disqualified Persons are consistent with fair market value; and
- establish the Rebuttable Presumption.

Even the best policies and procedures may not prevent all Excess Benefit Transactions from occurring. Having these policies and procedures in place, however, demonstrates a commitment to compliance that the IRS is likely to consider in deciding whether to revoke an Exempt Organization's tax-exempt status or to impose excise tax liability on Organization Managers.

Footnotes

47 Automatic Excess Benefit Transactions Are Fertile Exam Issues, CCH Federal Tax Weekly, ¶16 (May 13, 2004)(quoting Leonard J Henzke, Tax Law Specialist, IRS Exempt Organizations/Tax Exempt/Government Entities (TE/GE) Division).
48 Remarks of Sarah Hall Ingram, Commissioner, Tax Exempt and Government Entities, Internal Revenue Service, Before the

For more information, call **866-529-6600**, or visit **WoltersKluwerLR.com/HCCPM**

Wolters Kluwer