IRS Issues New Intermediate Sanctions Rules

In 1996, Congress created an "intermediate sanctions" excise tax imposed on persons receiving excess benefits in transactions with tax-exempt organizations. The IRS has now issued new regulations (the "Regulations") which became effective January 10, 2001. For the most part, the Regulations are consistent with regulations proposed in 1998. However, they provide helpful new guidance in a number of important areas.

Who is a "Disqualified Person?"
"Disqualified persons" subject to the intermediate sanctions tax include individuals or entities "in a position to exercise substantial influence over the affairs of an organization." Under the Regulations, an important factor in applying this subjective test is whether the person participates in management decisions affecting the tax-exempt organization as a whole or a discrete segment or activity that represents a substantial portion of the activities, assets, income or expenses of the tax-exempt organization. The Regulations provide three examples applying this test to tax-exempt hospitals:

- A radiologist employed by a tax-exempt hospital is not a disqualified person where the radiologist (1) supervises only radiology staff and does not manage any substantial part of the hospital's operations, (2) is not an officer or director of the hospital, and (3) receives compensation primarily in the form of a fixed salary.

- A cardiologist employed by a tax-exempt hospital is a disqualified person where (1) the cardiologist is the head of the cardiology department, (2) the cardiologist is not an officer or director of the hospital but has broad management authority over the cardiology department, and (3) the cardiology department is a major source of hospital admissions and represents a substantial portion of the hospital's income and activities.

- A management company is a disqualified person where it has broad day-to-day management authority over the operation of a hospital.

Liability of Organization Managers
Organization managers who "participate" in excess benefit transactions are subject to an excise tax of up to $10,000 per transaction. Under the Regulations, a manager participates not only where the manager approves or authorizes the transaction but where the manager is silent or fails to act if the manager is under a duty to speak or act.

Reliance by Manager on Professional Opinion
An organization manager will not be liable for the excise tax if the manager relies on a "reasoned written opinion of a professional with respect to elements of the transaction within the professional's expertise. Professionals may include legal counsel (including in-house counsel), accountants or independent valuation experts. The opinion is not a "reasoned" opinion if it merely recites the facts and then expresses a conclusion.

Initial Contract Exception
Fixed payments under an initial contract with a person who becomes a disqualified person at the time the contract is entered into are exempt from the intermediate sanctions rules. However, this "first bite" exemption is limited as follows:

- The contract must be a binding written contract.
- Payments must be a fixed amount or determined by a fixed formula (including a percentage of revenues or income) under which no person has discretion in calculating the payment amount.
- The exemption does not apply in any year in which the disqualified person fails to substantially perform his obligations under the initial contract.
- The initial contract loses its exemption on the earliest date on which the contract may be terminated by either party (other than for breach) without the other party's consent and without substantial penalty.
- The initial contract loses its exemption upon a material change to the contract, including an extension or renewal (other than an extension or renewal pursuant to the disqualified person's unilateral right to extend or renew provided in the initial contract).

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When Excess Benefit is Measured
In determining whether a disqualified person has received an excess benefit, when the reasonableness of payments is measured is critically important. The Regulations provide that the existence of an excess benefit is determined at the following times:

- For fixed payments or fixed-formula payments, as of the date the contract is executed.
- For fixed payments or fixed-formula payments where there is substantial non-performance, at any time up to and including the payment date.
- For variable payments, on the payment date and taking into account all facts through that date.

Approval of Compensation by Independent Board or Committee
As under the proposed regulations, the Regulations provide a rebuttable presumption that compensation payable to a disqualified person is reasonable (and therefore does not provide an excess benefit) if the compensation transaction is reviewed and approved in advance by an independent governing body comprised entirely of individuals who have no conflict of interest with respect to the compensation transaction. The Regulations broadly define an independent governing body to include the following:

- The governing body (e.g., board of directors or trustees) of the tax-exempt organization itself.
- The governing body of an entity controlled by the tax-exempt organization (e.g., the board of directors of a taxable subsidiary).

- A committee of the governing body, which may be composed of any individuals permitted under State law, provided that the committee is permitted by State law to act on behalf of the governing body.
- To the extent permitted by State law, other persons authorized by the governing body of the tax-exempt organization to act on its behalf by following procedures specified by the governing body.

Documentation of Independent Board Approval
In order to obtain the benefit of the rebuttable presumption for compensation transactions, the Regulations provide that the written records of the governing body must contain the following:

- The terms of the transaction approved and the date it was approved.
- The members of the authorized body who were present and how each member voted on the transaction.
- The comparability data obtained and relied upon and how the data was obtained.
- Any actions taken with respect to consideration of the transaction by any member of the governing body who had a conflict of interest with respect to the transaction.

Timing of Independent Board Approval
For fixed payment or fixed-formula payments, the compensation must be determined to be reasonable by the independent board or committee on or before the date the compensation transaction becomes effective. In the case of payments that are not fixed payments or fixed-formula payments, the approval process may not be used to establish a presumption of reasonableness until the exact amount of payment is determined, unless the payment is subject to a specified cap and that cap is determined to be reasonable by the independent board or committee. A "fixed formula" is one under which compensation may vary in a specified manner based on future events or contingencies (like productivity or revenues) or upon external objective measures (like CPI or other industry adjustors). A formula is not fixed if any person has discretion over the calculation of the amount of compensation or whether an adjustment to compensation will be made.

Nothing New on Revenue Sharing
The intermediate sanctions law authorized the IRS to create special rules for so-called "revenue-sharing" transactions in which a disqualified person's compensation is based in whole or in part on the revenues of the exempt organization. However, the IRS chose not to include any special rules for revenue-sharing transactions in the Regulations, and reserved the issue for future regulations.

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