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IRS Publishes Final Rules on Intermediate Sanctions

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On January 21, 2002, the IRS published final rules on the excise taxes that may be levied on employees of exempt organizations that engage in business deals that result in "excess benefits" to the individual employees or other insiders. Congress designed these excise taxes, commonly referred to as intermediate sanctions, to provide the Service with a tool for penalizing individuals at exempt organizations for violations of the rules against self-dealing. The final regulations apply to 501(c)(3) and 501(c)(4) organizations. In response to comments from the higher education community, the IRS has determined that these rules do not apply to public colleges and universities.

The following report is designed to explain what intermediate sanctions are, how they work, and how they can affect the decisions made by people who manage tax-exempt charitable organizations. Section I provides a general overview. The sections that follow provide more detailed discussions of specific aspects of these new penalty excise taxes. The footnotes provide references to the statute, legislative history, and temporary regulations. The report is based on interpretations provided in the final Treasury Regulations issued under section 4958 on January 21, 2002.

What Are Intermediate Sanctions?

Enactment of a New Tax. "Intermediate sanctions" is the name used to refer to penalty excise taxes that affect the activities of tax-exempt section 501(c)(3) and 501(c)(4) organizations. If a section 501(c)(3) or section 501(c)(4) organization allows any part of its net earnings to inure to the benefit of a private individual or shareholder, the organization will violate the requirements for tax-exempt status.[1]

[1] Section 501(c)(3) and section 501(c)(4). Note that the inurement proscription was added to section 501(c)(4) by the same law that created intermediate sanctions. (All section references are to the Internal Revenue Code.)

Until the enactment of intermediate sanctions, the only penalty the IRS could impose when faced with such a violation was revocation of the organization's tax-exempt status. Knowledgeable professionals familiar with tax-exempt charitable organizations had noted that such a penalty could be disproportionately harsh on the charitable organization in comparison to the violation and worked to the detriment of charity rather than the person extracting undue benefits from the charity for private gain. Congress studied the potential for providing the IRS with an alternative enforcement tool less severe than revocation. The Clinton Administration proposed a new set of penalty excise taxes that would fall on the person reaping the benefits from the charity rather than the charity itself.[2] Because these taxes were viewed as less severe than revocation of tax-exempt status and were designed to be proportional to the inurement involved, they came to be known as "intermediate sanctions." The new taxes were enacted, in substantially the same form as proposed by the Clinton Administration, as part of the Taxpayer Bill of Rights 2 on July 30, 1996.[3]

Description of the Tax. Intermediate sanctions have been codified as section 4958 of the Internal Revenue Code. Under section 4958, a tax applies to each *excess benefit transaction* involving a section 501(c)(3) or 501(c)(4) organization. An *excess benefit transaction* is a transaction in which the organization provides an economic benefit directly or indirectly to or for the use of a *disqualified person* and the value of the economic benefit exceeds the value of the consideration provided in return. A *disqualified person* is generally a person (including not only a natural person but also a trust, estate, association or corporation) in a position to exercise substantial influence over the affairs of the organization.[4] A *disqualified person* can also be a member of the family of an individual with substantial influence or an entity in which more than 35 percent of the ownership or beneficial interests are held by persons with substantial influence. The tax on the excess benefit transaction must be paid by the disqualified person who receives the benefit.

First and Second Tier Taxes; Correction of Excess Benefit Transactions. The tax on excess benefit transactions has two tiers. The first tier tax is equal to 25 percent of the excess benefit the disqualified person receives; i.e., 25 percent of the excess of the value of the benefit received over the value of the consideration received in return. The second tier tax is equal to 200 percent of the excess benefit the disqualified person receives. The disqualified person must pay the second-tier tax if the excess benefit transaction is not *corrected* before the IRS issues a notice of deficiency for or assesses the first-tier tax.

Separate Tax for Organization Managers. A separate tax is imposed under section 4958 on the participation of any *organization manager* in an excess benefit transaction, knowing it to be such a transaction, unless the participation is not willful, and is due to reasonable cause. The tax must be paid by the organization manager and is equal to 10 percent of the excess benefit. The maximum tax that can be imposed on the participation of organization managers is $10,000 per transaction. If more than one organization

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2 Statement of Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of the Treasury, Before the

3 Pub. L. No. 104-168, 110 Stat. 1452.

4 Section 4958(f)(1)(A).

manager is liable for the tax with respect to a single transaction, then each such manager is jointly and severally liable for the tax owed. An individual who is both a disqualified person and an organization manager can be liable for both the tax on the transaction itself and the organization manager tax.

Effective Date. Section 4958 was enacted on July 30, 1996. The tax on excess benefit transactions and the tax on participation in excess benefit transactions by organization managers apply generally to transactions occurring on or after September 14, 1995. There is an exception for transactions that occur pursuant to a contract that was binding before September 14, 1995.

Available Guidance. The Treasury Department issued proposed regulations on intermediate sanctions on July 30, 1998 and received a number of comments in response. It then issued a revised set of temporary and proposed regulations on January 10, 2001. Final regulations were issued on January 21, 2002.

Treatment of Intermediate Sanctions in Ongoing Enforcement Activities. The IRS National Office has issued guidance to the field instructing agents to refer cases that may involve intermediate sanctions to the National Office for coordination. It is not clear whether the Service will pursue this formal policy now that final regulations have been issued. Staff from the National Office have indicated that they may create a more informal coordinating structure to work with agents in the field.

Cases. The first Tax Court petitions have been filed on behalf of taxpayers challenging the IRS's proposed imposition of intermediate sanctions. A total of 13 petitions have been filed, all stemming from the same three interrelated transactions involving three nonprofit home health agencies located in Mississippi and the family members who controlled them. The IRS alleges that five members of the Caracci family used their substantial influence over Sta-Home Home Health Agency of Jackson, MS; Sta-Home Home Health Agency of Granada, MS; and Sta-Home Home Health Agency of Forest, MS to cause those nonprofits to transfer all of their assets to three for-profit corporations wholly-owned and controlled by the Caracci family. The for-profit corporations paid nothing in return for the assets. The Caraccis claim their local accountant provided a valuation concluding that the liabilities on the assets and the lack of interest from outside parties in the assets gave the assets a negative net value so that nothing was owed back to the nonprofits in the transfer. The IRS disagrees, claiming that the assets had a net value of approximately $18.5 million.

The IRS is seeking to revoke the exemption of each of the three nonprofits, retroactive to the date of the transaction, October 1, 1995. It is also seeking to collect approximately $41.7 million in taxes under section 4958 from each of five Caracci family members. The total includes the 25 percent first-tier tax and the 200 percent second-tier tax with respect to each of the three transactions as well as the maximum $10,000 organization manager tax with respect to the third transaction. (The failure to assert the organization manager tax with respect to the other two transactions is not explained.) The IRS is also seeking to collect taxes under section 4958 from each of the three for-profit corporations based on the proportion of the assets each for-profit received.

The cases are significant in several respects. First, they show the IRS is already using its intermediate sanctions authority for cases in the audit stream even though the regulations are not final and are prospective only. Second, they show how quickly a huge tax bill can accumulate with the addition of the 200 percent second-tier tax. Third, they show how the taxes give the IRS a new capacity to take action against the individuals who take a charity's assets rather than just the charity itself. Fourth, they show that although the enforcement apparatus is new, the alleged underlying offense is familiar: an inappropriate valuation used as a basis for allowing insiders to take over a charity's assets without paying their full fair market value. In this respect, the Sta-Home health agency cases are very similar to Anclote Psychiatric Center v. Commissioner, T.C. Memo 1998-273.

Which Organizations Are Affected by Intermediate Sanctions?

Applicable Tax-Exempt Organizations. Section 4958 applies to any excess benefit transactions involving an *applicable tax-exempt organization*. An *applicable tax-exempt organization* is an organization that is described in section 501(c)(3) or 501(c)(4) and is exempt from tax under section 501(a), without regard to the excess benefit transaction. (Because the excess benefit transaction would constitute inurement in violation of the requirements of section 501(c)(3) and section 501(c)(4), if taken into account it would have an effect on whether the organization was described in section 501(c)(3) or 501(c)(4).) There is also a five-year lookback rule. If the organization has been described in section 501(c)(3) or 501(c)(4) and exempt from tax under section 501(a) at any time during the five year period ending on the date of the transaction, then it is considered an *applicable tax-exempt organization* for purposes of section 4958. (For transactions occurring before September 14, 2000, the lookback period is less than five years. Instead, it is the period beginning September 14, 1995 and ending on the date of the transaction.). The regulations add two important clarifications:

(1) An organization that is not described in section 501(c)(3) or 501(c)(4) as a result of a final determination or adjudication is not an applicable tax-exempt organizations, as long as the denial or loss of adjudication was not based on participation in inurement or an excess benefit transaction. For example, if an organization loses its exemption under section 501(c)(3) because it engages in political campaign intervention, transactions it conducts after the event that triggers loss of exemption and before any new exemption is issued will not be covered by intermediate sanctions.[5]

(2) A governmental entity that is not subject to tax, irrespective of whether it has applied for exemption under sections 501(c)(3) or 501(c)(4) is not an applicable tax-exempt organization.[6] For example, a state college or

[5] Treas. Reg. § 53.4958-2(a)(5).

[6] Treas. Reg. § 53.4958-2(a)(2). Certain entities that are formed and operated under the auspices of state or local government, such as hospitals and universities do not need a section 501(c)(3) determination letter to be relieved of their federal income tax burden. If they are considered a part of the state or local government, they are not taxed under federal law, and even if they are not part of the government, section 115 of the Internal Revenue Code excludes from their gross income "derived from . . . the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia . . . ."

university is not subject to intermediate sanctions even though it has received a section 501(c)(3) determination letter to facilitate fundraising and to confirm that its faculty are eligible to receive benefits under a section 403(b) retirement plan. Governmental entities that are not subject to tax because of the application of section 115 are not applicable tax-exempt organizations. Furthermore, governmental units and affiliates of governmental units that are recognized as section 501(c)(3) organizations are not applicable tax-exempt organizations if they are relieved from filing annual information returns with the IRS under Treas. Reg. § 1.6033-2(g).

Which Organizations Are Considered Section 501(c)(3) Organizations? The proposed regulations make clear that for purposes of section 4958, an organization will be treated as described in section 501(c)(3) and exempt under section 501(a) only if the IRS is permitted to treat the organization as such under the rules of section 508.[7] Section 508 allows the IRS to treat an organization as described in section 501(c)(3) only if

- the IRS has given the organization a written determination that it is described in section 501(c)(3);[8]
- the organization is a church, an integrated auxiliary of a church or a convention or association of churches;[9] or
- the organization is not a private foundation, and its gross receipts in each taxable year are normally not more than $5,000.[10]

Which Organizations Are Considered Section 501(c)(4) Organizations? The proposed regulations make clear that for purposes of section 4958, an organization will be treated as described in section 501(c)(4) and exempt under section 501(a) only if

- the IRS has given the organization a written determination that it is described in section 501(c)(4);
- the organization has filed an application with the IRS for recognition of exemption under section 501(c)(4);
- the organization has filed an information return as a section 501(c)(4) organization under the IRC or accompanying regulations; or
- the organization has held itself out as being described in section 501(c)(4).[11]

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7 Treas. Reg. § 53.4958-2(a)(3).

8 Section 508(a)(1).

9 Section 508(c)(1)(A). There are no formal statutory or regulatory definitions of what constitutes a church. There, is however, regulatory guidance on what constitutes an "integrated auxiliary of a church." Under section 6033(a)(2)(A), churches, their integrated auxiliaries, and conventions or associations of churches are exempted from the requirement of filing an annual information return that applies to most other section 501(c)(3) organizations. Treas. Reg. § 53.6033-2(h) defines an integrated auxiliary of a church as an organization that is described in section 501(c)(3), is not a private foundation, is "affiliated with a church or convention or association of churches and [is] internally supported." Further guidance is then provided on the affiliation and internal support requirements. Three examples illustrate the operation of this standard.

10 Section 508(c)(1)(B).

Foreign Organizations. A foreign organization that receives substantially all of its support from sources outside of the United States is not an applicable tax-exempt organization for section 4958 purposes.[12] If a foreign organization receives enough support from sources inside the United States so as not to benefit from this exception, the foreign organization is subject to the same rules that apply to domestic organizations, including the rule requiring certain organizations to receive an IRS determination letter in order to be treated as an organization described in section 501(c)(3).

Who Is Considered a Disqualified Person?

General Statutory Definition. The statute defines a *disqualified person* to be, with respect to any transaction, "any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization."[13]

Members of the Family. The statute also says that an individual is also a disqualified person if he or she is a member of the family of another person who is a disqualified person because of his/her degree of influence over an organization. To be a member of the family, an individual must be a

- spouse
- brother or sister (including half-brothers and sisters)
- spouse of brother or sister
- ancestor
- child
- grandchild
- great grandchild
- spouse of child, grandchild or great grandchild.[14]

Note that aunts, uncles and cousins are not included in this list.

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11 Treas. Reg. § 53.4958-2(a)(4).

12 Treas. Reg. § 53.4958-2(b)(2). This position with respect to foreign organizations is mandated by section 4948(b) which provides that chapter 42 "shall not apply to any foreign organization which has received substantially all of its support (other than gross investment income) from sources outside the United States." Section 4958 is part of chapter 42.

13 IRC § 4958(f)(1)(A).

14 Sections 4958(f)(1), 4958(f)(4); Treas. Reg. § 53.4958-3(b)(1).

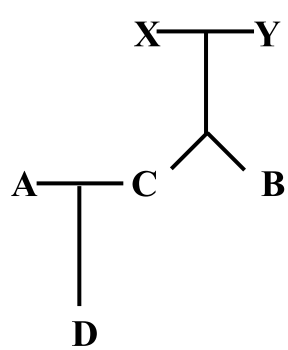
Thirty-five Percent Controlled Entities. The statute also says that a corporation, partnership, trust or estate is a disqualified person if persons with sufficient influence over the affairs of the organization and members of those persons' families own more than 35 percent of the voting, profits or beneficial interests in the entities.[15]

- For *corporations*, the test is whether disqualified persons hold more than 35 percent of the combined voting power. Voting power includes voting rights derived from direct and indirect holdings of voting stock but not voting rights held as a director or trustee.
- For *partnerships*, the test is whether disqualified persons hold more than 35 percent of the profits interests.
- For *trusts and estates*, the test is whether disqualified persons hold more than 35 percent of the beneficial interests.

For all of these entities, additional constructive ownership rules found in section 267(c) also apply.

- Stock, profits or beneficial interests owned, directly or indirectly by a corporation, partnership, trust or estate is treated as owned proportionately by shareholders, partners or beneficiaries.
- Stock, profits or beneficial interests owned by members of an individual's family (as described in this section) is treated as owned by the individual.
- Stock, profits or beneficial interests owned by an individual shall be treated as owned by the individual's partner.

The last two rules cannot be used to move more than one degree away from constructive ownership. For example,



A and C will be treated as owning constructively stock that C's brother B owns directly because A and C are members of B's family. However, A and C's child, D, will *not* in turn be treated as owning stock that her uncle B owns directly even though her parents are treated as owning it constructively.[16] For purposes outside the tax code, D may well

[15] Section 4958(f)(3); Treas. Reg. § 53.4958-3(b)(2).

[16] Section 267(c)(5).

be considered a member of B's family, but for purposes of intermediate sanctions, D is not a member of B's family.

Substantial Influence. The temporary regulations provide that certain individuals necessarily have the substantial influence to be disqualified persons by virtue of the powers and responsibilities of their positions. These individuals are as follows:

- Voting members of the organization's governing body;[17]
- Persons functioning as presidents, chief executive officers, or chief operating officers, or otherwise having ultimate responsibility for implementing the decisions of the governing body or supervising the management of the organization, regardless of their actual titles;[18]
- Persons functioning as treasurers or chief financial officers or otherwise having ultimate responsibility for managing the finances of the organization, regardless of their actual titles;[19] and
- Persons with a material financial interest in a provider-sponsored organization.[20]

The temporary regulations also deem certain persons *not to have substantial influence*. These persons are as follows:

- Other section 501(c)(3) organizations, whether they are public charities or private foundations[21]
- Other section 501(c)(4) organizations, but only where the applicable tax-exempt organization is itself a section 501(c)(4) organization[22]
- Employees receiving economic benefits that total less than the amount that would make the individual a highly compensated employee for certain employee benefits purposes (currently $80,000 per year) provided that the individual (1) does not have substantial influence by occupying one of the positions described above, (2) is not a disqualified person by virtue of being a

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[17] Treas. Reg. § 53.4958-3(c)(1).

[18] Treas. Reg. § 53.4958-3(c)(2).

[19] Treas. Reg. § 53.4958-3(c)(3). Note that there is a change here from the proposed regulations. In the temporary regulations, an individual is no longer defined as fulfilling the role of a chief financial officer merely because he or she has the authority to sign drafts or authorize electronic transfers of funds

[20] Treas. Reg. § 53.4958-3(c)(4). A provider-sponsored organization is defined in section 1853(e) of the Social Security Act. The mandate that these individuals be treated as disqualified persons derives from section 501(o) which was enacted as part of the Balanced Budget Act of 1997.

[21] Treas. Reg. § 53.4958-3(d)(1). Note that there is a change here from the proposed regulations, which allowed for the possibility that a private foundation would be a disqualified person.

[22] Treas. Reg. § 53.4958-3(d)(2).

member of the family of a person with substantial influence and (3) is not a substantial contributor to the organization.[23]

For all others persons, whether or not the person is a disqualified person depends upon all relevant facts and circumstances.[24] The temporary regulations identify certain factors that tend to show a person has substantial influence, and certain factors that tend to show a person does not have substantial influence.

Factors tending to show a person has substantial influence:

- The person founded the organization.
- The person is a substantial contributor to the organization, taking into account only the current year and the four preceding years, rather than the entire life of the organization.
- The person's compensation is primarily based on revenues derived from activities the person controls.
- The person has or shares authority to control or determine a significant portion of the organization's capital expenditures, operating budget or compensation for employees.
- The person manages a discrete segment or activity of the organization that represents a substantial portion of its activities, assets, income or expenditures.
- The person owns a controlling interest in a corporation, partnership or trust that is a disqualified person.
- The person is a non-stock organization controlled, directly or indirectly, by one or more disqualified persons.[25]

Factors tending to show a person does not have substantial influence

- The person has taken a bona fide vow of poverty as an employee or agent or on behalf of a religious organization.
- The person is an independent contractor, such as an attorney or accountant or investment manager, whose sole relationship to the organization is in that professional advisory capacity (rather than in a decisionmaking capacity), providing advice on transactions from which he will not economically benefit

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[23] Treas. Reg. § 53.4958-3(d)(3). An individual is a substantial contributor if the organization is a trust and the individual created the trust, or if the individual has contributed or bequeathed more than $5,000 to the organization, and the amount contributed constitutes more than 2 percent of the total contributions received by the close of the taxable year in which the contribution is given. § 507(d)(2). For example, if an organization has received $250,000 from its formation to the end of its second taxable year, and M has made multiple gifts totaling $6,000 to the organization during those two taxable years, M is a substantial contributor as if the date the total contributions exceeded $5,000. See Treas. Reg. § 1.507-6(b)(2) Ex. 1.

[24] Treas. Reg. § 53.4958-3(e).

[25] Treas. Reg. § 53.4958-3(e)(2).

directly or indirectly, other than through customary fees for professional advice.

- Any preferential treatment the person receives based on the size of the person's donation is also offered to any other donor making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions.
- The person's direct supervisor is not a disqualified person
- The person does not participate in management decisions affecting the organization as a whole or a discrete segment that represents a substantial part of the organization's activities, assets, income, or expenditures.[26]

The regulations include thirteen examples to illustrate the application of these factors.[27] The regulations also provide that where multiple section 501(c)(3) or 501(c)(4) organizations are affiliated, an individual's status as a disqualified person is tested separately for each organization.[28]

When Is a Transaction an Excess Benefit Transaction?

Standard for Identifying an Excess Benefit Transaction. An excess benefit transaction occurs when an *applicable tax-exempt organization* provides an economic benefit, directly or indirectly, to or for the use of a disqualified person, and the economic benefit is more than reasonable compensation for the services received in return or more than fair market value for the property received in return. The standard for what constitutes reasonable compensation or fair market value is based on the standards long used for purposes of the business expense deduction provided by section 162.[29] For fixed payments (see definition below under initial contract exception), the circumstances taken into account in determining whether compensation is reasonable are generally those in existence at the time the contract providing for the fixed payment is executed, not the time the compensation is paid. However, if there is substantial nonperformance, or if the payment is not a fixed payment under the contract, then all facts and circumstances through the date of payment are taken into consideration in determining reasonableness.[30]

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26 Treas. Reg. § 53.4958-3(e)(3).

27 Treas. Reg. § 53.4958-3(g). The examples cover a voting member of a broad-based membership organization, an artist who works part-time at a museum, a school headmaster, a program officer at a community organization, a company that manages a regular bingo fundraising operation for a charity, the owners of the bingo management company, a management company for a hospital joint venture, the dean of a law school at a large university, the chair of a small department at a university, a radiologist working on a hospital staff, a cardiologist heading the cardiology department at a hospital, an accountant providing professional advice to a museum, and a substantial contributor to a theater company.

28 Temp. Reg. § 53.4958-3T(f).

29 Temp. Reg. § 53.4958-4T(b)(1)(ii). The legislative history specifically directed that the section 162 precedents be used. Also consistent with the legislative history, the proposed regulations state that the fact that a State or local legislative body or agency has approved compensation does not mean that it is reasonable. Questions have been raised about the consequences of this provision for trustees whose fees are mandated and set by state law.

30 Treas. Reg. § 53.4958-4(b)(2)(i).

The final regulations provide that even if a payment in property is subject to a substantial risk of forfeiture, these timing rules will apply as long as the payment is a fixed payment.

Indirect Excess Benefit Transactions. The temporary regulations state that a benefit can be provided indirectly if it is provided by another entity that is controlled by the organization or through an intermediary.[31] An entity is controlled by the applicable tax-exempt organization if it owns more than 50 percent of the stock in the entity if it is a corporation or more than 50 percent of the profits interest if it is a partnership, controls the selection or has as representatives more than 50 percent of the board of the entity if it is a nonstock organization, or owns more than 50 percent of the beneficial interests in the entity if it is a trust or ha some other legal structure.[32] An indirect excess benefit transaction can take place through an intermediary if an economic benefit flows through the intermediary to a disqualified person and either there is evidence that there was understanding that the intermediary would use the economic benefit in this way or the intermediary lacked a business purpose or an exempt purpose for engaging in the transaction with the disqualified person.[33] The regulations provide four examples to illustrate what may constitute an indirect excess benefit transaction.[34]

Initial Contract Exception. The temporary regulations provide that fixed payments made under an initial contract are not subject to intermediate sanctions. A *fixed payment* is defined as "an amount of cash or other property specified in the contract, or determined by a fixed formula specified in the contract, which is to be paid or transferred in exchange for the provision of specified services or property."[35] An initial contract is any contract made with a person who is not a disqualified person at the time the contract is executed.[36] Thus, an individual being hired for the first time by a particular section 501(c)(3) or section 501(c)(4) organization need not worry that he or she will become subject to intermediate sanctions because the IRS subsequently concludes that the person's contract calls for excessive compensation, *provided* that the contract calls for fixed payments rather than compensation subject to discretionary adjustments. Fixed payments include amounts determined by formula, and fixed payment formulas can depend upon contingent events, including revenues generated by one or more of the organization's activities. The temporary regulations include eleven examples to illustrate how the initial contract exception applies.[37]

When the Initial Contract Ends. The special protection for fixed payments made under an initial contract ceases when the disqualified person enters into a new contract with the organization. The parties will be treated as entering into a new contract

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31 Treas. Reg. § 53.4958-4(a)(2).

32 Treas. Reg. § 53.4958-4(a)(2)(ii)(B).

33 Treas. Reg. § 53.4958-4(a)(2)(iii).

34 Treas. Reg. § 53.4958-4(a)(2)(iv).

35 Treas. Reg. § 53.4958-4(a)(3)(ii).

36 Treas. Reg. § 53.4958-4(a)(3)(iii).

37 Treas. Reg. § 53.4958-4(a)(vii).

- As of the date the organization can first unilaterally cancel or terminate the contract without cause
- As of the date any material change to the initial contract becomes effective. A material change includes, but is not limited to, any extension or renewal that is not exercisable unilaterally by the disqualified person and any more than incidental change to any amount payable under the contract.[38]

Disregarded Transactions. Certain transactions are *disregarded for purposes of section 4958.* The transactions themselves are not excess benefit transactions, and the amounts paid are not added to compensation or other transactions to determine whether they constitute excess benefit transactions. The disregarded transactions are as follows:

- Payment of any fringe benefit excludable from income under section 132. (The proposed regulations had disregarded only expenses for attending meetings of a governing body other than spousal travel or luxury travel. That language has been deleted in favor of the broader section 132 standard, which excludes amounts paid for spousal travel if it furthers the organization's exempt purpose or serves a bona fide business purpose, and covers expenses for travel undertaken primarily for a business purpose provided that the travel expenses are not lavish or extravagant.)[39]
- Amounts paid under a reimbursement arrangement that qualifies as an accountable plan.[40]
- Benefits provided to a disqualified person solely in that person's capacity as a volunteer for the organization if the benefits are provided to the general public in exchange for a membership fee of $75 or less per year.[41]
- Benefits provided to a member of an organization solely on account of payment of membership fees, or to a donor solely on account of a contribution, provided that the same benefits are available to all becoming members or making contributions above a specified dollar level, and payments above this level are made not only by a disqualified person but also by a "significant" number of disqualified persons.[42]
- Economic benefits provided to a disqualified person solely as a member of a charitable class that the organization intends to benefit.[43]

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[38] Treas. Reg. § 53.4958-4(a)(3)(v).

[39] Treas. Reg. § 53.4958-4(a)(4)(i).

[40] Treas. Reg. § 53.4958-4(a)(4)(ii).

[41] Treas. Reg. § 53.4958-4(a)(4)(iii).

[42] Treas. Reg. § 53,4958-4(a)(4)(iv). The regulations do not explain how an organization can know when it establishes a new set of benefits for a donor at a particular level whether it will have a significant number of donors giving at that level. Furthermore, if it has a reasonable expectation that it will have a significant number of such donors, but events intervene – like a decline in the stock market – to prevent those gifts from being realized, the regulations could penalize the disqualified person who was one of the few donors to make a large contribution and receive the benefits in return.

[43] Treas. Reg. § 53.4958-4(a)(4)(v).

- Economic benefits provided to a governmental unit in furtherance of exclusively public purposes.[44]

Compensation for Services. The regulations make clear that all economic benefits provided in return for services are included in compensation, including cash, deferred compensation, bonuses, severance payments, and fringe benefits other than de minimis fringe benefits and working condition fringe benefits.[45] If compensation includes a bonus or revenue-sharing arrangement, the use of a cap to limit the amount is relevant in determining whether the compensation is reasonable.[46]

Insurance or Indemnification. The regulations provide that purchasing insurance or providing indemnification to cover

- section 4958 taxes,
- expenses not reasonably incurred in connection with proceedings arising out of the person's performance of services for the section 501(c)(3) or 501(c)(4) organization, or
- expenses resulting for willful act or failure to act that was not due to reasonable cause does not, in and of itself, constitute an excess benefit transaction provided that the amount of the premium or the amount of the indemnification is included in the disqualified person's compensation.[47] (If the compensation is unreasonable, then the payment of the total amount of compensation, including the insurance benefit or indemnification, constitutes an excess benefit transaction.) Although this amount must be included in compensation for purposes of determining whether the compensation is reasonable for purposes of section 4958, it is not necessarily includible in the beneficiary's income for income tax purposes. For example, payment of the premium may be excludable as a de minimis fringe benefit.

Organization Must Demonstrate Intent to Provide Item as Compensation for Services. The statute clearly provides that "an economic benefit shall not be treated as consideration for the performance of services unless such organization clearly indicated its intent to so treat such benefit."[48] The regulations say that an organization must have written substantiation of its intent that is contemporaneous with the transfer of benefits.[49] It can substantiate by reporting the economic benefit on a Form W-2, 1099, 990 or the recipient can do so by reporting it on a Form 1040, 1040A or 1040EZ. Such a form has to have been filed before the IRS begins an examination in which the reporting of the benefit has been questioned. Alternatively, the written substantiation can consist of an employment contract executed before the benefit is transferred to the disqualified person

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44 Treas. Reg. § 53.4958-4(a)(4)(vi).

45 Treas. Reg. § 53.4958-4(b)(1)(ii)(B)(1).

46 Treas. Reg. § 53.4958-4(b)(1)(ii)(A).

47 Treas. Reg. § 53.4958-4(b)(1)(ii)(B)(2).

48 Section 4958(c)(1).

49 Treas. Reg. § 53.4958-4(c)(1).

or other similar contemporaneous documentation.[50] No substantiation of intent is required for benefits that are excluded from income, including employer-provided health benefits, contributions to a qualified pension, profit-sharing, or stock bonus plan, and employer-provided educational assistance.[51] If the organization fails to report the benefit and has no other written substantiation, and the failure to report is due to reasonable cause, such as a technological malfunction, and the organization responds in a responsible fashion, then it will be treated as if it had reported the item.[52]

Deferred Compensation. For benefits provided pursuant to a qualified pension, profit-sharing, or stock bonus plan, the transaction transferring the amount is treated as occurring when the benefit vests. For other transfers subject to a substantial risk of forfeiture, the transaction occurs when any substantial risk of forfeiture subsides.[53]

Revenue Based Compensation. The statute specifically directed the Treasury Department to write regulations specifying when revenue-based compensation resulted in inurement, and, consequently, an excess benefit transaction. The proposed regulations provided guidance on this subject under Prop. Reg. § 53.4958–5, but all of those provisions have been deleted in the temporary regulations. The preamble states that Treasury and the IRS will continue to study comments. They promise that any future regulations that may be issued governing revenue sharing will be prospective only. Meanwhile, the temporary regulations state explicitly that a contract can include a revenue-sharing formula and that a cap on the amount of compensation that can be paid under a revenue-sharing arrangement weighs positively toward finding the amounts paid to be reasonable. Thus, revenue sharing is not barred per se (though it was not barred under the proposed regulations either). At present, revenue-sharing arrangements are to be evaluated like any other form of compensation.

Embezzlement. The final regulations provide that amounts obtained by a disqualified person from an organization by theft or fraud are never to be treated as consideration for performance of services by the disqualified person.[54] Such an interpretation is consistent with the decision in Variety Club Tent No. 6 v. Commissioner, 74 T.C.M. 1485 (1997), which held that embezzlement by a charity's treasurer and one of its members did not constitute inurement.

When Is a Transaction Presumed Not to be an Excess Benefit Transaction? What Must an Organization Do in Order for this Rebuttable Presumption to Arise?

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50 Treas. Reg. § 53.4958-4(c)(3)(ii).

51 Treas. Reg. § 53.4958-4(c)(2). Although the organization is not required to substantiate its intent to provide these excludable benefits as compensation for services, the benefits are included in compensation for purposes of determining whether the compensation is reasonable *unless* they are explicitly excluded from compensation under Treas. Reg. § 53.4958-4(a)(4).

52 Treas. Reg. § 53.4958-4(c)(3)(i)(B)

53 Treas. Reg. §§ 53.4958-1(e)(2); 53.4958-4(b)(ii)(B)(1).

54 Treas. Reg. § 53.4958-4(c)(1).

Availability of a Rebuttable Presumption. Although section 4958 does not provide directly for any presumptions, the legislative history that accompanied it specifically directed that if an organization approved a transaction after following specified procedures, a rebuttable presumption should arise that the transaction provided for payment of reasonable compensation or fair market value, and, therefore, did not constitute an excess benefit transaction.[55] The temporary Treasury regulations under section 4958 provide for such a rebuttable presumption. The presumption arises if

- The compensation arrangement or property transfer is approved by the organization's governing body or a committee of the governing body composed entirely of individuals who do not have a conflict of interest with respect to the arrangement or transaction;

- The governing body, or committee thereof, obtained and relied upon appropriate data as to comparability prior to making its determination; and

- The governing body or committee thereof adequately documented the basis for its determination concurrently with making that determination.[56]

The rebuttable presumption can also arise where the approval process is handled by the governing body of an organization controlled by the applicable tax-exempt organization. Controlled organizations are defined in the same way used in defining what may constitute an indirect excess benefit transaction.[57]

Delegation of Approval Procedures. The governing body may delegate responsibility for following the procedures necessary to give rise to the rebuttable presumption. The delegation must specify the procedures to be followed. If the designees do in fact follow the procedures, their actions shall have the same effect as if the board had acted itself.[58] However, if the designees act, but their actions cannot take effect absent ratification by the full governing body, then the transaction is not treated as having been approved by the designees for purposes of the rebuttable presumption.[59]

Conflicts of Interest. To meet the first procedural requirement, the parties approving the transaction may not have any conflicts of interest with respect to the transaction. An individual will have a conflict if

- The individual is the disqualified person or is related to any disqualified person benefiting from the compensation arrangement or transaction.

- The individual is in an employment relationship subject to the direction and control of any disqualified person participating in or benefiting from the transaction.

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55 H. Rep. 104-56, 104th Cong. 2d Sess., pp. 56-7.

56 Treas. Reg. § 53.4958-6(a).

57 Treas. Reg. § 53.4958-6(a)(1).

58 Treas. Reg. § 53.4958-6(c)(1)(C).

59 Treas. Reg. § 53.4958-6(c)(1)(i)(B).

- The individual is receiving compensation or other payments subject to the approval of any disqualified person participating in or benefiting from the compensation arrangement or transaction.

- The individual has a material financial interest affected by the compensation arrangement or transaction.

- The individual will in turn have his or her compensation arrangement or transaction approved by the disqualified person participating in the compensation arrangement or transaction being approved.[60]

If an individual has a conflict of interest, he or she can avoid participation in the approval process by, when the governing body or committee is approving the transaction, the individual recusing himself from the meeting and not being present during debate and voting on the transaction.[61]

Appropriate Data on Comparability. Generally, the individuals approving the transaction are looking for data to show what similarly situated organizations paid for similar services under similar circumstances. This data can include information taken from taxable as well as tax-exempt organizations.[62] Whether data on comparable compensation or transactions is appropriate and adequate depends upon the knowledge and expertise of the individuals relying on the data. There is no prescribed form for the data. It may be a survey or appraisal compiled by a independent firm. It may be a written offer from a competitor. It may be a survey conducted by the organization itself.

If the organization has annual gross receipts of less than $1 million—using a rolling three year average[63]—then having data on compensation paid by three comparable organizations in the same or similar communities for similar services will be considered appropriate data as to comparability.[64]

Appropriate data includes not only customized surveys prepared by specialized consultants, but also published national surveys and other published sources of information.[65] A survey done in a previous year can be appropriate data if the board or committee using the survey has no information to suggest the relevant market has changed.[66] Where compensation for services is at issue, written offers from competitors are appropriate data, and where a sale of property is at issue, offers from others bidding in an open and competitive process are appropriate data. However, the data must be relevant to the question being evaluated. One of the examples included in the temporary regulations indicates that undifferentiated data from a large national compensation survey

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60 Treas. Reg. § 53.4958-6(c)(1)(iii).

61 Treas. Reg. § 53.4958-6(c)(1)(ii).

62 Treas. Reg. § 53.4958-6(c)(2)(i).

63 Treas. Reg. § 53.4958-6(c)(2)(iii).

64 Treas. Reg. § 53.4958-6(c)(2)(ii).

65 Treas. Reg. § 53.4958-6(c)(2)(ii); Temp. Reg. § 53.4958-6(c)(2)(iv) Ex. 2.

66 Treas. Reg. § 53.4958-6(c)(2)(iv) Ex. 4.

is likely not to constitute appropriate data if the individuals using it lack the expertise to make the distinctions necessary to apply the aggregated data to their organization.[67]

Documentation. The governing body or committee must prepare a written record of their approval process. The records must be prepared before the later of the next meeting of the governing body or committee, or 60 days after the date of approval. The record must be approved as reasonable, accurate and complete within a reasonable period of time after the records have been prepared.[68] The record must contain the following information:

- The terms of the transaction that were approved and the date it was approved;
- The members of the governing body or committee who were present during debate and those who voted on it;
- The comparability data obtained and relied upon and how the data was obtained;
- The actions taken by anyone who was otherwise a member of the governing body or committee who had a conflict of interest; and
- If the amount approved varies from the comparables considered, the basis for the deviation, whether higher or lower.[69]

Benefit of Presumption. If an organization follows the prescribed procedures, the Service must assemble sufficient contrary evidence to counter the value of the comparability data used by the governing body in approving the compensation.[70] There is no adverse consequence for an organization solely from having failed to follow the procedures that give rise to the presumption.[71] Tax will be imposed only if the transaction is in fact an excess benefit transaction. Furthermore, the presumption will apply to all payments made in accordance with a contract that is approved in accordance with the required procedures.[72] The procedures do not have to be repeated for each payment.

Time At Which Presumption Can Arise. For fixed payments, the presumption can arise when the contract providing for the fixed payments is executed. For non-fixed payments subject to a cap, the presumption can arise when the contract providing for the payments and the cap is executed, provided that fixed payments at the level of the specified cap would constitute reasonable compensation as shown by comparability data,

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67 Treas. Reg. § 53.4958-6(c)(2)(iv) Ex. 1.

68 Treas. Reg. § 53.4958-6(c)(3)(ii).

69 Treas. Reg. § 53.4958-6(c)(3).

70 Treas. Reg. § 53.4958-6(b).

71 Treas. Reg. § 53.4958-6(e).

72 Treas. Reg. § 53.4958-6(f).

and the other criteria for the rebuttable presumption are met.[73] (However, the IRS can still rebut a presumption that arises under these circumstances with all facts and circumstances, up to and including circumstances in existence on the date the amount of the payment is determined.) For non-fixed payments that are not subject to a cap, the presumption will not arise until it is possible to determine whether the compensation to be paid will be reasonable.[74]

Once an Excess Benefit Transaction Has Occurred, Is There Any Way to Avoid the First-Tier Tax on the Transaction? How Do You Correct an Excess Benefit Transaction in Order to Avoid the Second-Tier Tax?

Abatement of the First-Tier Tax. Under section 4962, the first-tier tax imposed by section 4958 shall be abated if it can be established to the satisfaction of the Secretary that

- the excess benefit transaction was due to reasonable cause and not to willful neglect; and

- the excess benefit transaction was corrected within sufficient time after the mailing of the notice of deficiency with respect to the second tier tax.[75]

Generally, the disqualified person is given 90 days after the mailing of the notice of deficiency to complete the correction, as well as any additional time that a suit with respect to the second-tier tax is pending in Tax Court, but the Secretary has the discretion to give as much additional time as he or she determines is reasonable and necessary.[76]

Abatement of Second-Tier Tax. Under section 4961, the second-tier tax imposed by section 4958 shall be abated if the excess benefit transaction is corrected within sufficient time after the mailing of the notice of deficiency with respect to the second tier tax. As for the abatement of the first-tier tax, generally, the disqualified person is given 90 days after the mailing of the notice of deficiency with respect to the second-tier tax to complete the correction, as well as any additional time that a suit with respect to the second-tier tax is pending in Tax Court, but the Secretary has the discretion to give as much additional time as he or she determines is reasonable and necessary.[77]

Correction. Correcting an excess benefit transaction requires undoing the excess benefit to the extent possible and taking any additional steps necessary to make the organization no worse off than it would be if the disqualified person had not taken excess benefits.[78] With two exceptions, correction must be accomplished by repaying the organization an

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73 Treas. Reg. § 53.4958-6(d)(2).

74 Treas. Reg. § 53.4958-6(d)(1).

75 Section 4962(a).

76 Section 4963(e).

77 Section 4963(e).

78 Section 4958(f)(6); Treas. Reg. § 53.4958-7(a).

amount of money equal to the excess benefit as well as an interest amount.[79] The interest rate is the applicable Federal rate for the month in which the excess benefit transaction occurred.[80] The first exception is for nonqualified deferred compensation that has vested but not yet been distributed to the disqualified person.[81] The disqualified person can correct a transaction involving payment of the deferred compensation by disclaiming any right to receive that part of the vested benefits that represents excess benefits. The other exception permits a disqualified person to correct by returning property that has been the subject of an excess benefit transaction, but only if the organization agrees to take the property back.[82] The disqualified person may also have to pay additional cash to the organization if the returned property is worth less on the day returned than it was on the day the excess benefit transaction occurred.

If an organization and disqualified person enter into a contract that provides for a series of payments over time, and one of the early payments is determined to constitute an excess benefit transaction, correction does not necessarily require termination of the contract. However, the terms of the contract may need to be modified to avoid future excess benefit transactions.[83]

When Is an Organization Manager Liable for the 10 Percent Tax?

Standard for Imposition of Organization Manager Tax. A tax is imposed on the participation of any organization manager who participates in an excess benefit transaction, knowing it to be such a transaction, and whose participation is willful and not due to reasonable cause. The tax is equal to 10 percent of the excess benefit and must be paid by the organization manager or managers who meet the standard. If more than one manager has participated in an excess benefit transaction and meets the standard for liability, joint and several liability applies.

Parallel to Tax Imposed on Private Foundation Managers. The tax on organization managers is closely modeled on the tax on foundation managers imposed under the self-dealing rules of section 4941. A foundation manager who participates in an act of self-dealing with a private foundation, knowing it to be such an act and whose participation is willful and not due to reasonable cause, must pay a tax equal to 2.5 percent of the amount involved in the act of self-dealing.[84] A second tier tax equal to 200 percent of the amount involved also applies.[85]

Who Is an Organization Manager? The statute defines *organization managers* to be any officer, director, or trustee of such organization or any individual having powers or

[79] Treas Reg. § 53.4958-7(b)(1), (c).

[80] Treas. Reg. § 53.4958-7(c).

[81] Treas. Reg. § 53.4958-7(b)(3).

[82] Treas. Reg. § 53.4958-7(b)(4).

[83] Treas. Reg. § 53.4958-7(d).

[84] Section 4941(a)(2).

[85] Section 4941(b)(1).

responsibilities similar to those held by officers, directors, or trustees.[86] The regulations expand on this definition to say that the person must exercise general authority to make decisions on behalf of the organization. Merely recommending decisions without the authority to implement them without approval of a superior is not sufficient. Independent contractors, such as attorneys and accountants, acting as advisors and not officers or directors are not organization managers.[87] However, the proposed regulations also make clear that if an individual is not a regular member of the governing body but does serve on a committee of the governing body that approves transactions as part of the organization's efforts to give rise to the rebuttable presumption, than that individual is an organization manager.

What Is Participation? There is no full definition of this term. The regulations add the following interpretation, drawn directly from the model created under section 4941.[88]

Participation includes silence or inaction on the part of an organization manager where the manager is under a duty to speak or act, as well as any affirmative action by such manager. However, an organization manager will not be considered to have participated in an excess benefit transaction where the manager has opposed such transaction in a manner consistent with the fulfillment of the manager's responsibilities to the applicable tax-exempt organization.[89]

When Is Participation Knowing, Willful, and Not Due to Reasonable Cause? The regulations again track the private foundation self-dealing rules in interpreting this standard. To be knowing, the organization manager's participation must be based on actual knowledge of enough facts to make out a case that the transaction is an excess benefit transaction, be aware that the transaction may be such a transaction, and negligently fail to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction.[90] To be willful, the organization manager must participate voluntarily, consciously and intentionally. Motive is not relevant, but participation cannot be willful unless it is also knowing.[91] Finally, an organization's manager's participation is due to reasonable cause if the manager has exercised ordinary business care and prudence.[92]

Opinion of Professional Safe Harbor. The regulations contain a safe harbor that also parallels the model created under section 4941, though it expands upon it. This safe harbor provides that an organization's manager's participation will "ordinarily" not be considered knowing, willful and not due to reasonable cause if the manager relies on an opinion from certain types of professionals, provided that it is in the form of "a reasoned

86 Section 4958(f)(2).

87 Treas. Reg. § 53.4958-1(d)(2)(i)(B).

88 Treas. Reg. § 53.4941(a)-1(d)(3).

89 Treas. Reg. § 53.4958-1(d)(3).

90 Treas. Reg. § 53.4958-1(d)(4).

91 Treas. Reg. § 53.4958-1(d)(5).

92 Treas. Reg. § 53.4958-1(d)(6).

written opinion of that professional with respect to elements of the transaction within the professional's expertise."[93] Eligible professionals include only the following:

- Legal counsel, including in-house counsel;
- Certified public accountants or accounting firms with expertise on tax law matters;
- Independent valuation experts who hold themselves out as appraisers or compensation consultants, perform valuations on a regular basis, are qualified to value the type of property or services involved, and certify in their opinion that they meet the three criteria just mentioned.[94]

The criteria for the valuation experts are based on the criteria an appraiser must meet in order to provide an appraisal required to support a charitable contribution deduction of property worth more than $5000. Thus, if a valuation expert provides a written opinion that compensation being paid to a disqualified person is reasonable, and the opinion contains the required certifications, and the officers and directors rely on that opinion in setting that person's compensation, the officers and directors will generally be protected from the organization manager's tax.

Additional Safe Harbor—Related to Rebuttable Presumption. An organization manager's participation will "ordinarily" not be considered knowing if the elements of the rebuttable presumption have been satisfied with respect to the transaction.[95]

If an Organization Is Subject to Intermediate Sanctions, May the Organization's Tax Exemption also Be Revoked?

The enactment of section 4958 does not affect the standards for exemption under section 501(c)(3) or section 501(c)(4). Organizations must respect the prohibition against inurement in order to be described in those sections.[96] The preamble to the proposed regulations addressed how the relationship between intermediate sanctions and revocation of tax-exempt status will be handled as an enforcement matter. The preamble included the following statement.

The IRS intends to exercise its administrative discretion in enforcing the requirements of section 4958, 501(c)(3) and 501(c)(4) in accordance with the direction given in the legislative history. The legislative history specifically provides that the IRS may still revoke the tax-exempt status of an organization for violating the inurement proscription, with or without imposition of section 4958 excise taxes. It further provides that, in practice, the excise taxes imposed by section 4958 will be the sole sanction imposed in those cases in which the excess benefit does not rise to a level where it calls into question

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93 Treas. Reg. § 53.4958-1(d)(4)(iii).

94 Id.

95 Treas. Reg. § 53.4958-1(d)(4)(iv).

96 Treas. Reg. § 53.4958-8(a).

whether, on the whole, the organization functions as a charitable or other tax-exempt organization. In determining whether an excess benefit transaction rises to such a level, factors relating to the organization's general pattern of compliance with the requirements of section 501(c)(3) or (4) and other applicable Federal and State laws will be taken into account. These factors would include whether the organization has been involved in repeated excess benefit transactions; whether, after concluding that it has been party to an excess benefit transaction, the organizations has implemented safeguards to prevent future recurrences; and whether there was compliance with other applicable laws. The IRS intends to publish the factors that it will consider in exercising its administrative discretion in guidance issued in conjunction with the issuance of final regulations under section 4958.[97]

No guidance was published to accompany the final regulations. Until it publishes an expanded list of factors, the IRS said it would consider all relevant facts and circumstances in the administration of section 4958 cases.

If the IRS Wishes to Investigate Whether a Church or an Integrated Auxiliary of a Church Has Engaged in an Excess Benefit Transaction, Must the IRS Follow the Church Audit Procedures?

Section 7611 prohibits the IRS from beginning a church tax inquiry or examination unless a Regional Commissioner[98] or higher Treasury official reasonably believes, based on a written record of facts and circumstances, that the church may not be exempt from tax under section 501(a) or may be carrying on an unrelated trade or business or other activities subject to federal taxation. A church tax inquiry or examination is defined to be an inquiry directed to the church or an examination of church records or religious activities for the purpose of determining whether under the facts and the applicable law, the church is not exempt from tax under section 501(a) or is liable for unrelated business income tax or other federal tax.[99] An inquiry or examination for the purpose of determining whether a church has been involved in an excess benefit transaction, is arguably not subject to the restrictions of section 7611 because such an inquiry or examination is not for the purpose of determining whether the church is exempt from tax under section 501(a), liable for unrelated business income tax or liable for another federal tax.[100] Nevertheless, the Treasury regulations make clear that the IRS will follow the same procedures that are mandated by section 7611 when conducting an inquiry or

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97 I.R.B. 1998-34, p. 11.

98 The reorganization of the IRS has eliminated the position of Regional Commissioner. IRS identify the appropriate officials with the authority to initiate a church tax inquiry or examination.

99 Section 7611(h)(2) and (3).

100 An inquiry or examination for the purpose of determining whether an excess benefit transaction has occurred is also an inquiry or examination that will determine whether there has been any inurement that violates the requirements of section 501(c)(3). If the relationship between revocation of exempt status and imposition of intermediate sanctions is a matter only of enforcement discretion, and if that discretion is not exercised until after the existence of inurement is established, then it could be argued that an inquiry or examination for the purpose of determining whether intermediate sanctions apply would also be an inquiry or examination for the purpose of determining whether revocation was appropriate. It would follow from this argument that section 7611 would apply to an inquiry or examination for the purpose of determining whether an excess benefit transaction involving a church has occurred.

examination to determine whether an excess benefit transaction has occurred between a church and a disqualified person.[101]

Other Procedural Issues

Statute of Limitations. If an organization discloses an item in its annual information return (Form 990) sufficient to put the IRS on notice of the existence and nature of the item, the three-year limit on assessment and collection will run from the due date for the return. If the item is not adequately disclosed, there will be a year six-year limitation on assessment and collection running from the due date for the return.[102] These rules for limitations apply even though the return is filed by the organization and not by the disqualified person who would be liable for the section 4958 tax.[103]

Challenging a Section 4958 Tax in Tax Court. A disqualified person may challenge the imposition of a section 4958 tax in Tax Court.[104] The taxpayer generally has ninety days after the issuance of a notice of deficiency to file a petition in Tax Court. However, that period may be extended if the Service has granted additional time for correction.[105]

Refund Claims. The disqualified person has three years from the time the relevant return is filed paying the section 4958 tax (Form 4720) to claim a refund. Payment of the first-tier tax shall be enough for the taxpayer to bring a refund claim and maintain an action with respect to the second-tier tax as well.[106]

For More Information

The final rules on intermediate sanction were published in the *Federal Register* on January 23, 2002, pages 3076-3099. For more information on the final rules, contact Phyllis D. Haney at the Internal Revenue Service by phone at 202-622-4290. The NACUBO contact is Mary M. Bachinger. She can be reached by e-mail at mary.bachinger@nacubo.org or by phone at 202-861-2581.

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[101] Treas. Reg. § 53.4958-8(b); Treas. Reg. § 301.7611-1, Q&A-19.

[102] Treas. Reg. § 301.6501(e)-1(c)(3)(ii) (as it would be amended by the proposed intermediate sanctions regulations).

[103] Treas. Reg. § 301.6501(n)-1(a) (as it would be amended by the proposed intermediate sanctions regulations).

[104] Section 6213(a). The tax imposed by section 4958 is a tax imposed under chapter 42 and, therefore, is within the scope of this section.

[105] Treas. Reg. § 301.6213-1(e) (as it would be amended by the proposed intermediate sanctions regulations).

[106] Treas. Reg. § 301.7422-1(b) (as amended by the proposed intermediate sanctions regulations).