TAXATION SECTION

The District of Columbia Bar

Sixth Floor
1250 H Street, N.W.
Washington, D.C.
20005-5937
(202) 626-3463
FAX (202) 626-3453

Sections EventLine
(202) 626-3455

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Comments on "Intermediate Sanctions"Legislation

Prepared by the Exempt Organizations Committee, Section of Taxation

One-Page Summary for D.C. Bar Reviewers

The IRS is preparing regulations to implement new legislation enacted this summer, and has requested public comment to be taken into account even before temporary or proposed regulations are published. The legislation imposes penalty taxes on public charities and certain other tax-exempt organizations if they provide an "excess benefit" to an organization insider (referred to as a "disqualified person"). A rebuttable presumption that the transaction does not involve an excess benefit may be established if the organization's board of directors follows a three-step process including obtaining data on comparable transactions and documenting the basis for its belief that the transaction is reasonable at the time of the transaction.

We have prepared comments recommending that the IRS provide the following guidance in the forthcoming regulations or in other published form:

First, we recommend that an organization's donors should be treated as "disqualified persons" under the statute if they fall within the definition of "substantial contributors" in the private foundation rules, but with two modifications to those rules: (1) they must have contributed more than $5,000 or 15 percent of the total contributions received by the organization, rather than $5,000 or 2 percent as provided under the private foundation rules, and (2) in applying this test, total contributions during the previous five years should be taken into account, rather than total contributions since the establishment of the organization. Accordingly, under the latter provision, substantial contributor status, once established, would not necessarily be permanent.

Second, we recommend that the Service regularly publish a table setting ceiling compensation levels by size of organization, as measured by annual expenditures. Organization employees who otherwise qualify as "disqualified persons" under the statute but whose compensation packages are below the ceiling compensation levels would be excepted from the definition of disqualified person.

Third, we recommend that organizations that follow the procedures to establish a rebuttable presumption that compensation paid to their senior executives is reasonable be allowed to rely on that presumption for five years as long as annual raises during that period are limited to no more than a specified percentage over the Consumer Price Index and there is no material reduction in the disqualified person's duties or time spent working on behalf of the organization. We recommend that the specified percentage be within the range of 7-10 percent.

Comments in Response to Notice 96-46

Prepared by the Exempt Organizations Committee
Section of Taxation, District of Columbia Bar[1]

I. Substantial Contributors as Disqualified Persons

The Taxpayer Bill of Rights 2 contains a new Internal Revenue Code Section 4958. Section 4958 imposes new excise taxes as "intermediate sanctions" on a "disqualified person" who engages in and benefits from an "excess benefit transaction" with Section 501(c)(3) organizations (other than private foundations) or Section 501(c)(4) organizations. The new excise taxes imposed on a disqualified person by Section 4958 include (1) a first-tier penalty tax equal to 25 percent of the amount of the excess benefit, and (2) a 200 percent excise tax if the excess benefit is not corrected within the statutory correction period.[2]

Section 4958(f)(1) defines a "disqualified person" as any person who was, at any time during the 5-year period ending on the date of the transaction, "in a position to exercise substantial influence over the affairs of the organization," as well as certain family members of such persons and certain "35 percent controlled" entities owned by one or more disqualified persons.

Determining which individuals may be disqualified persons is central to administering the new statute, and one of the issues causing great concern is how to determine which individuals are "in a position to exercise substantial influence over the affairs of the organization."

The Section 4946 statutory definitions of disqualified persons under the private foundation rules are a logical starting point for determining who will be treated as a disqualified person under the new law, particularly in light of the fact that for purposes of those rules, a disqualified person has been described generally by the Service as a person who stands in a position to exert influence over the foundation.[3] Moreover, the statutory language and legislative history of the new provision expressly state that certain provisions of Section 4946 and the regulations thereunder will be used in determining whether particular individuals will be deemed to be a disqualified person for purposes of Section 4958.

Under Section 4946, a substantial contributor to a private foundation is treated as a

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[1]The views expressed herein represent only those of the Section of Taxation of the District of Columbia Bar and not those of the District of Columbia Bar or its Board of Governors. The Section of Taxation is comprised of approximately 1,500 members. These materials were prepared by Cynthia M. Lewin and Barbara L. Kirschten of the Exempt Organizations Committee and approved by the Steering Committee of the Section on Taxation (Stephen J. Csontos, Judith C. Dunn, and Kathleen M. Nilles having recused themselves.)

[2]A separate tax is imposed on any organization manager who knowingly participates in an excess benefit transaction.

[3]See Gen. Couns. Mem. 37946 (May 4, 1979).

disqualified person. As defined in Section 507(d)(2) and Treasury Regulation Section 1.507-6(a)(1), a substantial contributor is any person whose aggregate contributions and bequests to a private foundation as of the end of any taxable year are more than $5,000 if such amount is more than 2 percent of the total gifts and bequests received from all sources by the foundation before the close of the foundation's taxable year in which a contribution or bequest is received. If the foundation is a trust, the creator of the trust is a substantial contributor, regardless of the amounts contributed or bequeathed. A substantial contributor may be an individual, trust, estate, partnership, association, company or corporation.[4] Generally, once a person becomes a substantial contributor with respect to a private foundation, he remains as such (even after death), even though his aggregate contributions and bequests subsequently become less than 2 percent of the total received by the foundation (e.g., due to subsequent contributions and bequests by other persons.)

We believe that a substantial contributor should be considered a disqualified person for purposes of Section 4958 only if it is likely that that person, in fact, would be in a position to exercise substantial influence over the organization. To make this determination, we believe that the same general rules governing substantial contributors in the private foundation context should be applied to Section 501(c)(3) public charities and Section 501(c)(4) organizations. However, because of the effect of the permanency of substantial contributor status under the private foundation rules[5] and because of the different concerns that arise from private foundation (rather than public charity or Section 501(c)(4)) status,[6] we believe that for purposes of Section 4958, two modifications should be made to the existing substantial contributor rules.

First, in applying the rules of Section 507(d)(2), only gifts, grants, contributions, and bequests made by an individual within the organization's 5 fiscal years immediately preceding an excess benefit transaction, rather than all aggregate contributions or bequests made by such individual, should be taken into account in determining whether the individual is a disqualified person. Taking into account only amounts contributed or bequeathed within 5 fiscal years immediately preceding an excess benefit transaction would provide a more realistic assessment of whether the individual is in fact in a position to exercise substantial influence over the affairs of the organization, and would not so significantly restrict the individual, or family members of the individual, from engaging in transactions with the organization as do the current private foundation substantial contributor rules. As part of this change, the permanent nature of substantial contributor status under the private foundation rules would be

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[4]Governmental units, other private foundations and public charities described in Sections 509(a)(1), 509(a)(2), and 509(a)(3), or any organization owned by such public charities, are excepted from substantial contributor status.

[5]For example, because of the rule that family members are also disqualified persons, an individual who makes a large contribution to a foundation that causes that person to become a substantial contributor, members of his family are all disqualified persons, which may significantly limit family members' transactions with the foundation long after the individual's death.

[6]The donor base of a public charity or a section 501(c)(4) is generally significantly broader than that of a private foundation, and control of such organizations is less likely to be limited to representatives of a single family or corporate donor. Moreover, due to a broader donor base, the administrative burden of identifying substantial contributors would be significantly greater for a public charity or section 501(c)(4) organization than for a private foundation.

modified.

Second, we believe that the 2 percent threshold of Section 507(d)(2) is too low in the context of public charities and Section 501(c)(4) organizations, and particularly, in the case of start-up organizations. In our experience, 2 percent contributors in fact are almost never in a position to exercise substantial influence over the affairs of a public charity or Section 501(c)(4) organization. Instead, we recommend that an individual's aggregate contributions and bequests of more than $5,000, if such amount is more than 15 percent of the total gifts and bequests received from all sources by the organization during the organization's immediately preceding 5 fiscal years, should be taken into account in determining whether the individual is a substantial contributor to the organization. It is more likely that such a donor would be in a position to exercise substantial influence over the affairs of the organization.

Proposed regulatory language implementing these concepts follows:

PROPOSED REGULATION:

"Reg. Section 53.4958- __ Substantial contributor defined. (a) *Definition*--(1) *In general.* Except as provided in subparagraph (2) of this paragraph, the term "substantial contributor" means, with respect to a section 501(c)(3) organization (other than a private foundation) and a section 501(c)(4) organization, any person defined in section 507(d)(2) and the regulations thereunder.

"(2) *Special rules.* For purposes of section 4958, the term "substantial contributor" means with respect to a section 501(c)(3) organization (other than a private foundation) and a section 501(c)(4) organization, any person who contributed or bequeathed an aggregate amount of more than $5,000 to the organization during the organization's 5 fiscal years immediately preceding the excess benefit transaction, if such amount is more than 15 percent of the total contributions and bequests received by the organization during the organization's 5 fiscal years immediately preceding the excess benefit transaction."

II. Exclusion of Employees Receiving Low Compensation from Definition of "Disqualified Person"

The legislative history to the Taxpayer Bill of Rights 2 provides a three-step procedure for organizations to follow in order to establish a rebuttable presumption that compensation paid to senior executives who qualify as disqualified persons is reasonable. For smaller organizations, with limited financial resources and staff, gathering the comparability data required under the three-step procedure will be burdensome. Many such organizations are likely to choose to undertake it anyway, not because of any question that their compensation may be excessive but simply because of a sense that the new legislation means they "should" do it. Indeed, many advisors are already recommending that the three-step procedure be generally followed as a matter of good nonprofit management.

The result will be scarce resources diverted from the organizations' charitable missions to administrative activity. For organizations whose senior executives' compensation is clearly reasonable under any standard -- which includes a very large number of charitable organizations, particularly

those offering direct social welfare services -- this is wasteful and unnecessary.

The legislative history gives the Secretary of the Treasury the authority to exempt "broad" categories of individuals from the category of "disqualified person," including, for example, "full-time bona fide employees who receive economic benefits of less than a threshold amount." H. Rep. No. 506, 104th Cong., 2d Sess. 58 (1996) (emphasis added). We strongly recommend that the Service issue a table setting ceiling amounts on compensation for various sizes of organizations. Full-time employees whose total compensation is beneath the ceiling would be excluded from the definition of "disqualified person." Similarly, regular part-time employees whose total compensation is beneath the ceiling on a pro rata basis would also be excluded.

We believe that simply setting one threshold compensation amount for all organizations would not provide sufficient relief. The amount would likely have to be very low to deal with extremely small organizations with minimal financial resources or staff. Many somewhat larger organizations also should benefit from the exclusion provided by the table.

Size is obviously an appropriate consideration because larger organizations require managers with more skills and experience, and to attract those managers, such organizations must pay higher compensation. A key question is how to measure size for this purpose.

In large part, the answer depends on how size is measured in the compensation data that are available. While we have not made a comprehensive survey of available sources of compensation data, the sources we have seen have used a number of different measures: annual expenditures, contributions raised from outside sources, number of employees, and total assets. Another possible measure is annual gross receipts, which is used as an approximator of size for the Form 990-EZ filing requirement.

We believe that the use of annual expenditures as a measure for this purpose has several advantages. Annual expenditures is a reasonably good indicator of the size of an organization's staff and operations -- and hence of the appropriate compensation level for the individual running that organization (although it fails to take into account organizations where management of volunteers is a major responsibility). Also, our experience is that for organizations setting compensation, total annual expenditures is a key consideration, so that compensation levels for organizations with similar annual expenditures are more likely to be similar than if other possible measures are used. Additionally, annual expenditures can be tied to an existing IRS concept with which organizations are familiar -- the total expenditure lines from the Form 990-EZ and Form 990. Last, we have seen several data sources that focus on annual expenditures or annual budgets.

Total contributions raised from outside sources seem less tied to the setting of compensation than annual expenditures or annual receipts. Studies based on an organization's number of employees are not based on an existing IRS concept and also do not seem likely to capture the complexity of different types of organizations as well as some of the other measures do. While we would not object to the use of annual gross receipts as a measure, given its advantages of familiarity through the Form 990-EZ filing requirement and relationship to salary size for many organizations, we have not seen data sources based on gross receipts. Further, gross receipts could be distorted in any year by an organization's capital campaign.

The total asset concept is used primarily in compensation surveys of private foundations. We

do not think it is a useful measure in the public charity context, where many smaller organizations expend funds as soon as they come in and where the regulatory scheme is not based on asset size, as with private foundations.

Overall, we think total annual expenditures is the best measurement for which data are available. Further, we see no need to use an asset limit in conjunction with an annual expenditures test, similar to what is done with the Form 990-EZ filing requirement. If an organization is paying compensation low enough to come within the compensation ceiling set based on its annual expenditures, it should receive the benefit of the exclusion even if it has significant assets. (Indeed, while the focus of this approach would be to provide relief to smaller organizations, larger organizations that pay compensation levels beneath the ceilings applicable to smaller organizations should certainly be able to rely on the table as well.)

The size of each total annual expenditures bracket -- i.e., the dollar amount included in each bracket -- would depend on several factors. First, of course, is the availability of data with a sufficient level of detail by size of organization. Second is the sensitivity of the relationship between increased total annual expenditures and increased compensation. At higher levels of total annual expenditures, we expect that a larger increase in expenditures would be needed to produce an increase in compensation. The brackets, for example, could be as follows:

Total Annual Expenditures	Compensation Ceiling
under $100,000	
$100,000-$299,999	
$300,000-$499,999	
$500,000-$749,999	
$750,000-$999,999	
$1,000,000-$1,249,999	
$1,250,000-$1,499,999	
$1,500,000-$1,749,999	
$1,750,000-$2,000,000	

Despite geographic variations in salaries around the country, we would recommend that one table would be sufficient for the entire country. The purpose of the statute is to prevent private inurement, and the likelihood that private inurement is occurring anywhere in the country at the kinds of salary levels that would be included in the table is very slim.

The table would most likely be issued in the form of a revenue procedure, and would need to be scheduled for periodic updates, e.g., every year or every few years, based on how often the compensation sources used to prepare it are updated. We would be available to work with the Service at its request to assist in compiling compensation data and preparing such a table.

III. Application of Rebuttable Presumption To Multi-Year Personnel Relationships

The legislative history to the Taxpayer Bill of Rights 2, H. Rep. No. 506, 104th Cong., 2d Sess. 56-57 (1996) establishes a rebuttable presumption, under which compensation arrangements (as

well as certain other transactions) will be presumed reasonable if the arrangement was approved by a board of directors or trustees (or committee thereof) that:

(1) was composed entirely of individuals unrelated to and not subject to the control of the disqualified person(s) involved in the arrangement;

(2) obtained and relied upon appropriate data as to comparability (e.g., compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the location of the organization, including the availability of similar specialties in the geographic area; independent compensation surveys by nationally recognized independent firms; or actual written offers from similar institutions competing for the services of the disqualified person); and

(3) adequately documented the basis for its determination (e.g., the record includes an evaluation of the individual whose compensation was being established and the basis for determining that the individual's compensation was reasonable in light of that evaluation and data).

The Secretary of the Treasury and IRS are instructed to issue guidance in connection with the reasonableness standard that incorporates this presumption. Id.

In preparing such guidance, we believe the issue of the application of the presumption to an ongoing personnel relationship should be addressed. Compiling comparable salary data for a senior executive staff person who qualifies as a disqualified person will often involve substantial work -- determining which organizations are comparable, both geographically and in size; identifying the functionally comparable position within that organization; attempting to correct for unavoidable differences; and obtaining data on the complete compensation packages. After the presumption has been established initially, we believe that it should not be necessary to undertake this major effort again each year in order to receive the benefit of the presumption, as long as the only material change in the personnel relationship from the previous year is that the executive has received a reasonable annual raise. On the other hand, the benefit of the presumption should not be indefinite; years of healthy annual raises can push a longtime executive's salary well out of the range of comparables over time.

Thus, two policy concerns are competing here -- the need to minimize the administrative burden required to maintain the presumption as opposed to the need to limit the benefit of the presumption to cases where the reasonableness of the compensation has fairly been established. To achieve a balance between these concerns, we believe the Service should provide that if, after establishing the rebuttable presumption, an organization limits its raises to an executive to a maximum specified by the Service, the organization should be able to rely on the rebuttable presumption without repeating the three-step process for a certain number of years. We strongly recommend that this concept be incorporated into the forthcoming guidance in some form.

As to the particular form it should take, our view is that a ceiling based on a percentage over the Consumer Price Index ("CPI") would be appropriate for the maximum annual raise. Organizations should be able to keep their executives' compensation constant in current dollars, plus provide a merit increase based on performance. Based on our experience with nonprofit organizations, we recommend a ceiling within the range of 7-10 percent over CPI for a maximum salary increase within the

rebuttable presumption. This ceiling will allow nonprofit boards to give raises across a wide range, up to a significant raise to reward excellent performance, but not one, we think, that could cross the line into inurement.[7] We understand that some organizations will want to provide larger merit increases, and this provision certainly would not be intended to dissuade them. However, if those organizations wish to rely on the presumption, they would have to go through the three-step procedure at the time of the increase to establish it.

For purposes of calculating the increase in salary, benefits based on salary, such as contributions to retirement plans, should not be taken into account, as long as the benefit plans were in existence and properly taken into account at the time the rebuttable presumption was established and the basis on which contributions to the plans are calculated has not materially changed since that time. This approach avoids complexity in calculations; further, given nondiscrimination requirements and deferral limitations, such plans already offer only limited opportunities for inurement.

We also think that an organization that provides a smaller raise in one year should be able to make it up in a later year as long as the amount is no more than would have been earned if a raise at the ceiling level had been provided annually. Some organizations, such as those that receive government or private foundation grants on a two- or three-year cycle or have temporary funding shortfalls, are simply not in a position to give an annual raise.

Regarding the number of years during which the presumption can be relied on without updating the comparability data, we recommend five years. This is consistent with the legislation's two five-year "lookback" periods, one applying the statute to anyone who qualified as a disqualified person at any time during the five-year period prior to a particular transaction and the other applying it to organizations that were Section 501(c)(3) or Section 501(c)(4) organizations at any time during the 5-year period preceding a particular transaction. From an administrative standpoint, it provides a significant block of time during which the organization can rely on the presumption without having to follow additional procedures, yet limits the potential for inurement by requiring the organization to check its compensation against that of comparable organizations every five years and justify any differences if it wishes to continue to rely on the presumption.

Proposed regulatory language establishing this concept, which would presumably follow the regulations describing the rebuttable presumption itself, follows:

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[7]We note that a recent nonprofit salary survey shows that chief executives of nonprofits across the country and across all kinds of groups received an average raise of 5.9 percent from 1995 to 1996, compared to 2.5 percent inflation. Chief executives of health and social service groups received an average raise of 7.1 percent during the same time period, or 4.6 percent over inflation. See Towers Perrin, "Compensation Survey Report of Management Positions in Not-for-Profit Organizations," *cited in* The Chronicle of Philanthropy (Sept. 19, 1996) at 50. If the average raise was 4.6 percent over inflation, then presumably a sizeable number of such chief executives received raises in the 5-7.5 percent range. In that light, it is apparent that the proposed ceiling within a 7-10 percent range would not provide excessive room for a significant raise to reward excellent performance -- and perhaps not enough, given that the statutory intent is not to prescribe compensation for nonprofit executives, but simply to prevent excess benefit.

PROPOSED REGULATION:

"(a) If the rebuttable presumption for the compensation arrangement of a disqualified person who is a bona fide employee of the organization has been properly established, the organization may continue to rely on that rebuttable presumption with regard to that disqualified person for a period of five years from the date the compensation is approved, provided that (i) the only element of the compensation package that is changed during the five-year period is that the disqualified person's compensation is increased by an amount equal to no more than [insert figure in 7%-10% range] percent above the Consumer Price Index (the twelve-month U.S. City Average Consumer Price Index for Urban Wage Earners calculated monthly by the Bureau of Labor Statistics, U.S. Department of Labor) annually, and (ii) there is no material reduction in the disqualified person's duties or time spent working on behalf of the organization. If the disqualified person has been replaced, the presumption must be reestablished with regard to the new person in the position.

"(b) For purposes of determining whether compensation has been increased by an amount no more than [insert figure in 7%-10% range] percent above the Consumer Price Index, the value of increased contributions to any retirement and similar plans based on the increase in the disqualified person's salary shall be disregarded so long as the plans were in existence and properly taken into account at the time the rebuttable presumption was established and the basis on which contributions to the plans are calculated has not been materially changed since that time.

"(c) If one or more compensation increases below the ceiling were made in prior years, an increase in a later year may exceed the ceiling, as long as the total compensation payable following the increase does not exceed the compensation than would have been payable if an increase at the ceiling level had been provided annually.

"Example 1: Organization O properly establishes a rebuttable presumption for its compensation arrangement with its new executive director E. Following E's first year of service, the board approves a raise of 4 percent above the Consumer Price Index. Following E's second year of service, the board approves a raise of 6 percent above the Consumer Price Index. Following each of E's third and fourth years of service, the board approves a raise of 7 percent above the Consumer Price Index. O may rely on the rebuttable presumption with respect to E's compensation for the entire five-year period.

"Example 2: The facts are the same as in Example 1, except that following E's fifth year of service, the board approves a raise of 5 percent above the Consumer Price Index. O may not rely on the rebuttable presumption with respect to E's compensation unless O follows the three-step process to reestablish the presumption with regard to E's entire compensation package. Following the three-step process with regard only to the size of E's raise will not establish the presumption."