The IRS issued two little-known rulings in late 2002, and in each case imposed intermediate sanctions excise taxes. These rulings illustrate how the IRS finds weak points in an exempt organization’s support for compensation paid to an executive, and then exploits that weakness to conclude that the compensation was excessive. Exempt organizations can learn several lessons from these rulings about how to build a stronger defense against intermediate sanctions risk for their executive compensation arrangements.

As exempt organizations consider these rulings, it is important to bear in mind the critically important “rebuttable presumption of reasonableness” under the Section 4958 intermediate sanctions rules. An exempt organization qualifies for the rebuttable presumption if it meets three conditions:

1. **Independence**. The compensation arrangement must be considered and approved solely by independent members of the governing board (or committee of the board), who are unrelated to and not subject to the control of the person(s) involved in the compensation arrangement.

2. **Market Data**. The independent board or committee must obtain and rely on appropriate comparability data, such as compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions.

3. **Record**. The independent board or committee must adequately document the basis for its determination, and its meeting minutes must describe in detail the entire process by which it intended to qualify for the presumption.

Because the IRS has an easier time requiring a nonprofit to prove that executive compensation was reasonable than to prove the highest dollar amount that the IRS would consider reasonable, the battleground in future disputes will most likely be the rebuttable presumption. If there is any chance that the nonprofit has not completely met the three-part test, the IRS is likely to exploit that weakness in an effort to place the burden of proving reasonableness back on the nonprofit. The two recent rulings are prime examples of this IRS approach.

**Technical Advice Memorandum 200243057**

This TAM addressed whether a used car salesman, who created a tax-exempt organization to accept donations of used vehicles (in exchange for tax deductions), received an “excess benefit” under Section 4958. The IRS concluded that the salesman (and his family members) were “disqualified persons” with respect to the exempt organization and had received various types of excess benefits under Section 4958. To support its conclusion to assess intermediate sanctions excise taxes, the IRS analyzed issues as follows:

1. A resignation letter sent to the salesman by the organization’s accountant detailed facts that jeopardized the organization’s tax-exempt status. Unlike documents protected from discovery by the attorney-client privilege, this letter was readily discoverable and apparently served as a “roadmap” for the IRS.

   **Lesson One:** Any written assessments of strategy and conclusions as to legal risk should be prepared by legal counsel and clearly protected by the attorney-client privilege.

2. Compensation amounts paid to the salesman were not approved by the organization’s board, and were not supported by evidence of the services provided by the salesman. As a result, the IRS presumed that 100% of the compensation amounts constituted a Section 4958 excess benefit. The burden was placed on the taxpayer to prove the portion of compensation that might be considered reasonable.
Lesson Two: Make it clear which compensation amounts are subject to the rebuttable presumption of reasonableness process. Any amounts left out of the process are likely to be presumed unreasonable by the IRS.

3. The governing board had a duty (according to the IRS) to make efforts to obtain repayment of any payments known by the board to be improper. Because the board failed to do so, the payments constitute a Section 4958 excess benefit.

Lesson Three: The Board must take the primary role in reviewing and approving all forms of compensation to executives. If the Board believes any payment may be improper or excessive, it has an affirmative duty to correct the situation.

4. A fringe benefit provided to the salesman (in the form of a leased automobile) by the organization was not substantiated as compensation (i.e., the organization did not prove that it intended the auto lease payments to be treated as compensation). As a result, the entire value of this benefit was treated as an “automatic” Section 4958 excess benefit.

Lesson Four: The rebuttable presumption process should apply to every form of compensation provided to potentially disqualified persons. Fringe benefits in particular are presumed to be entirely subject to intermediate sanctions unless they are treated as compensation and approved in a manner that qualifies for the rebuttable presumption.

5. In all, the IRS concluded that 11 forms of salary, benefits, and other forms of remuneration constituted excess benefit transactions under Section 4958.

Lesson Five: The IRS will leave no stone unturned in its quest for unreasonable compensation. The Board or Committee must be aware of, review and approve all arrangements.

This line of reasoning (and other similar examples in the TAM) illustrate the types of arguments the IRS can make in a Section 4958 case, as well as the keen interest of the IRS in thoroughly examining every type of pay or benefit provided by an exempt organization to a disqualified person.

Technical Advice Memorandum 200244028

This TAM addressed several technical, but critical, issues in analyzing Section 4958 liability and the availability of the rebuttable presumption of reasonableness. The primary subject of the TAM was a consulting agreement between an exempt organization (a large hospital system) and both its CEO (who was resigning) and the CEO’s spouse.

It should be noted that consulting agreements (typically containing a covenant not to compete, as was the case in this TAM) are frequently used by large exempt organizations to transition from a CEO to his or her successor. The common nature of these arrangements underscores the importance of carefully considering this TAM.

In analyzing the consulting agreement and the compensation provided under it, the IRS made critical findings that could have broad application to similar types of arrangements, namely:

1. Because a five-year lookback period is used under Section 4958 to determine whether someone is a disqualified person, this former CEO continued for the entire five-year consulting period to be a disqualified person.

Lesson Six: Do not assume that, once an executive ceases to serve in an executive position, the intermediate sanctions risk ends. Any payments made within five years after executive status ends must be supported as reasonable.

2. Although a board-level committee went through a process intended to qualify for the rebuttable presumption of reasonableness, the second prong of the three-part test (requiring the approval body to obtain and rely on appropriate comparability data) was not met for the following reasons:

(a) Although the committee received and relied on a report from an independent compensation consulting firm, the record did not indicate that any committee members had “particular knowledge or expertise” in determining the reasonableness of a hospital CEO’s compensation.

Lesson Seven: Make sure that inside or outside expertise is present at the review and approval meeting, and demonstrate the expertise in the meeting minutes. This can be done in several
ways, including having outside expertise present (by phone or in person) at the meeting.

(b) The committee obtained and relied on the consultant’s report nine months after the effective date of the consulting agreement.

Lesson Eight: Use current comparability data, or indicate in the meeting minutes why the comparability data remains valid despite the passage of time since the data was gathered.

(c) The committee did not specifically address certain compensation elements (such as whether the payments made to the CEO’s spouse would be reasonable in relation to her services).

Lesson Nine: Make sure that the meeting minutes provide a complete picture of the Board’s or Committee’s rebuttable presumption process. This includes all compensation elements reviewed, the data to which the compensation elements were compared, and the reasoning of the Board or Committee as to why the approved elements were considered to be reasonable.

Because the second prong was not met, the TAM concluded that the IRS could place on the taxpayer the burden of proving the amount of compensation considered reasonable for the services provided.

3. The amount of compensation allocable to the CEO’s spouse must be analyzed for reasonableness by taking into consideration the value provided by the spouse alone, based on the spouse’s education, experience, knowledge of the health care industry, services for the organization, and ability to harm the organization through services for a competitor. The IRS does not permit reasonableness to be determined for the former CEO and spouse as a “team.” The clear implication of the TAM is that it would be difficult to demonstrate sufficient value by the CEO’s spouse to prevent the finding of an excess benefit under Section 4958.

Lesson Ten: Consider and support the reasonableness of every disqualified person’s compensation — including amounts paid for services provided by the spouses of executives.

The IRS analysis in this TAM indicates again the importance of qualifying fully for the rebuttable presumption of reasonableness. By failing to have the comparability data in hand before the consulting agreement went into effect, and by failing to demonstrate that sufficient expertise was available to the committee at the time of initial approval, the exempt organization lost the presumption and placed the entire arrangement at risk of triggering intermediate sanctions excise taxes. It is not sufficient to make sure that comparability data finds its way into the file at some point. The timing of these steps, and the record that is built, is critically important.

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These IRS rulings demonstrate how seriously the IRS takes this process, and how hard the IRS will work to undermine the rebuttable presumption and to place the burden of proving reasonableness on the exempt organization. The IRS also has announced its intention to focus on this area in coming months.

The rebuttable presumption continues to be the most important protection an exempt organization can have for its executive compensation arrangements. With proper planning and good professional advice from an independent compensation consultant and from legal counsel, an exempt organization can ensure that its review and approval process fares better than those addressed in these recent rulings.

If you would like additional information regarding the topics addressed in this memorandum, please contact any member of the HR Law Department or Health Law Department. Members of these departments are listed on the Gardner Carton & Douglas website at www.gcd.com.