The following comments on the temporary and proposed regulations under section 4958 (REG-246256-96),\(^1\) are the individual views of the members of the Section of Taxation and the Health Law Section and do not represent the position of the American Bar Association, the Section of Taxation, or the Health Law Section. Those who have contributed to these comments may not necessarily agree in all respects with the conclusions and recommendations expressed.

These comments were prepared by individual members of the Subcommittee on Intermediate Sanctions of the Committee on Exempt Organizations of the Section of Taxation and members of the Tax and Accounting Interest Group of the Health Law Section. Principal responsibility was exercised by Robert H.M. Ferguson, Victoria B. Bjorklund, Bernadette Broccolo, Frederick J. Gerhart, and Michael A. Clark. These comments were reviewed on behalf of the Section of Taxation by Carolyn M. Osteen for the Section of Taxation’s Committee on Government Submissions and by Douglas M. Mancino, the Council Director for the Committee on Exempt Organizations. The comments were reviewed by Bonnie Brier and Gregory L. Pemberton on behalf of the Health Law Section.

Although the individuals who participated in the preparation of these comments have clients who would be affected by, or have advised clients on the application of, the

---

\(^1\) The notice of proposed rulemaking, 66 Fed. Reg. 2173, cross-referenced the temporary regulations published in the Federal Register as Treasury Decision 8920, 66 Fed. Reg. 2144. Because the preamble to the regulations and their text was published in T.D. 8920, the citations to particular sections of the temporary and proposed regulations will reference the regulations as “Temp. Reg.”
temporary and proposed regulations, no participant (or the firm or organization to which such participant belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.


Date:  April 10, 2001

**Introduction**

Section 4958 of the Internal Revenue Code of 1986 ("Code") was enacted on July 30, 1996. In response to a public request for comments in advance of the issuance of proposed regulations, the members of the ABA Tax Section’s Committee on Exempt Organizations submitted comments in March of 1997. Proposed regulations were issued on August 4, 1998, and members of the Committee on Exempt Organizations submitted comments on February 24, 1999 ("Proposed Regulation Comments").

The regulations issued in both temporary and proposed form with respect to section 4958 on January 10, 2001 (the “temporary regulations”) provide much needed comprehensive guidance and reflect an obviously careful effort to respond to the numerous public comments that were submitted. In this regard, the temporary regulations did not include the provisions of section 53.4945-5 of the regulations issued in proposed form in 1998, reserving for further study the subject of applying taxes under section 4958 to certain types of revenue sharing transactions that violate section 501(c)(3)’s prohibition on private inurement. In general, the temporary regulations provide administrable and understandable rules that are consistent with
the statute and its legislative history. In addition, the preamble to the temporary regulations provides additional helpful clarification of the provisions of the temporary regulations. However, as set forth in the detailed comments below, we believe that certain provisions should be reconsidered and that others could benefit from additional clarification.

**Comments on Temp. Reg. § 53.4958-2T**

**Temp. Reg. § 53-4958-2T(a)(1)—Definition of “governmental entity”**

The preamble to the temporary regulations notes that comments on the proposed regulations requested that the status of “section 115 governmental entities” be clarified. The preamble further notes that “[i]n response to these comments, the temporary regulations provide that any governmental entity that is exempt from (or not subject to) taxation without regard to section 501(a) is not an applicable tax-exempt organization for purposes of section 4958. The last sentence of Temp. Reg. § 53-4958-2T(a)(1) provides that “[a] governmental entity that is exempt from (or not subject to) taxation without regard to section 501(a) is not an applicable tax-exempt organization for section 4958 purposes.” (emphasis supplied)

Section 115 exempts from taxation income of organizations that accrues to the benefit of states or political subdivisions in situations where the organization might not itself be a “governmental unit” referred to in sections 170(b)(1)(A)(v) and 170(c)(1) or otherwise commonly regarded as a “governmental entity.” To avoid any possible confusion about the intent of the regulation, we suggest that the sentence quoted above be modified to add, after the phrase “governmental entity,” the phrase “(including an entity that is not subject to taxation as a result of section 115).”
Comments on Temp. Reg. § 53.4958-3T

Temp. Reg. § 53.4958-3T(d)(2)—Section 501(c)(4) organizations

The temporary regulations exclude from disqualified person status certain types of individuals and entities not deemed to have substantial influence with respect to an applicable tax-exempt organization. Temp. Reg. § 53.4958-3T(d). Section 501(c)(4) organizations are deemed not to have substantial influence, but “[o]nly with respect to an applicable tax-exempt organization described in section 501(c)(4)” that has applied for section 501(c)(4) status, filed information returns claiming section 501(c)(4) status, or has otherwise held itself out as described in section 501(c)(4). Temp. Reg. § 53.4958-3T(d)(2). The preamble notes that comments were received requesting that section 501(c)(4) organizations be excluded from disqualified person classification but does not contain any explanation as to why the temporary regulations limit this treatment only to transactions with respect to other section 501(c)(4) organizations. 66 Fed. Reg. 2148.

As noted in the Proposed Regulation Comments, the Taxpayer Bill of Rights 2, the same legislation that introduced section 4958, also added the private inurement proscription (in language identical to that contained in section 501(c)(3)) to the definitional requirements of an organization described in section 501(c)(4). Both section 501(c)(3) and section 501(c)(4) organizations are thus subject to the same inurement prohibition. Indeed, as recognized by the regulations under section 501(c)(4), organizations formed under section 501(c)(4) to promote the social welfare also generally could be classified as section 501(c)(3) organizations, unless the organization is an “action” organization or participates in campaign activities. See Treas. Reg. §1.501(c)(4)-1(a)(2).
It is inappropriate to classify section 501(c)(4) organizations as disqualified persons when such organizations are, like section 501(c)(3) organizations, equally subject to the private inurement proscription at which section 4958 was directed. Many section 501(c)(4) civic organizations are affiliated with charitable and educational section 501(c)(3) organizations, and it would be administratively burdensome for such organizations to have to evaluate all transactions between the organizations for compliance with the rebuttable presumption of reasonableness. We thus continue to recommend that all section 501(c)(4) organizations be excluded from classification as disqualified persons. Thus, we suggest that Temp. Reg. § 53.4958-2T(d)(2) be amended to eliminate all language prior to the phrase “this category,” and to provide that “this category includes any organization described in section 501(c)(4) and exempt from tax under section 501(a).”

**Donor Advised Funds**

In the preamble to the temporary regulations (T.D. 8920), the Service asked for comments regarding the potential issues raised by applying the fair market value standard of section 4958 to distributions from a donor advised fund to (or for the use of) the donor or advisor of such fund.

We note that section 4958 already applies to sponsoring charities of donor advised funds. Treating each donor advised fund inside a sponsoring charity as an operating department (or division) raises numerous questions, including whether such treatment would require a legislative change and whether sponsoring charities should be singled out among all public charities for such treatment.
We considered whether to provide detailed comments regarding the application of the fair market value standard of section 4958 to distributions from a donor advised fund to (or for the use of) a donor or advisor. Upon reflection, however, we decided that such comments might best come from sponsoring charities of donor advised funds, including community foundations, the national donor advised funds, and other public charities.

**Temp. Reg. § 53.4958-3T(e)(2)(iii)--Revenue-Based Compensation**

The temporary regulations’ definition of “disqualified person” includes as a factor tending to show substantial influence the fact that a “person’s compensation is primarily based on revenues derived from activities of the organization that the person controls.” Temp. Reg. § 53.4958-3T(e)(2)(iii). The corresponding section of the proposed regulations contained the same factor without the word “primarily.”

The addition of “primarily” was a significant improvement. Nonetheless, this factor is still overly broad. It is increasingly common for tax-exempt organizations to use contingent compensation arrangements that include productivity as a factor (and sometimes a very important factor) in determining the participant’s eligibility for a level of contingent compensation. Many who participate in such contingent compensation plans do not have substantial influence over the organization. This is especially true for health care organizations where operating losses and other factors are influencing a trend toward making productivity incentives a larger and larger part of professional compensation.

An example is a health care system that has a primary care physician network, including a remote office staffed by one pediatrician. As the only physician at the site, the pediatrician controls all the revenue generated at the site. If that pediatrician’s compensation
consists of a $50,000 base salary and incentive compensation of up to an additional $100,000 based on meeting personal productivity measures, that pediatrician may be a disqualified person even though the pediatrician never sets foot in the system’s administrative offices.

To characterize the pediatrician in this example as a disqualified person is an overly broad application of the disqualified person definition. Moreover, to base a person’s status as a disqualified person solely on revenue-based compensation that the person controls seems inconsistent with the decision to reserve the section 53.4958-5 of the 1998 proposed regulations for further study. For the same reasons that it is prudent to devote further study to, and to reserve judgment on, the extent to which revenue-sharing ventures should be characterized as per se excess benefit transactions, it also would be prudent to reserve judgment on whether basing a person’s compensation on revenues that the person controls is by itself a basis for disqualified person status.

The expansive reach of this factor discourages organizations from legitimate uses of incentive compensation to require, as well as reward, employee productivity. In the more than 30 years since Rev. Rul. 69-383, 1969-2 C.B. 113, was issued, revenue-based compensation has become increasingly accepted and widely used. Merely because an employee’s compensation is weighted heavily with incentives does not mean that the employee has substantial influence over the organization. As organizations place greater emphasis on productivity, expense control, and other incentives, this factor will become more problematic.

If it is decided to retain this factor in Temp. Reg. § 53.4958-3T(e)(2), the revenues controlled by the person should at least be substantial in relation to the organization’s total revenues. This “substantiality” standard permeates the definition of disqualified person. If
compensation based primarily on revenues controlled by a person is to be a factor by itself, without more, the revenues controlled by the person should be a substantial part of the organization’s revenues.

To add a substantiality test, we suggest inserting the following clause at the end of Temp. Reg. § 53.4958-3T(e)(2)(iii): “, provided that such revenues controlled by the person represent a substantial part of the organization’s total revenues.” In addition, Example 10 in Temp. Reg. § 53.4958-3T(g) should be amended to reflect the fact that the revenues controlled by X are not a substantial part of the hospital’s revenues.

Comments on Temp Reg. § 53.4958-4T


Example 6 involves the application of the initial contract exception, illustrating that E, a newly hired chief operating officer who was not a disqualified person prior to being hired by Hospital B, is a disqualified person after being hired but is protected by the initial contract exception. Example 6 goes on to describe E’s ownership of more than 35 percent of Company X, which subsequently enters into a contract to provide billing and collection services to Hospital B. Example 6 concludes that the contract between Company X and Hospital B is not protected by the initial contract exception.

Example 6 makes a worthwhile and valid point. It would be helpful, however, to clarify under what circumstances Company X would be protected by the initial contract exception if its contract with Hospital B were entered into concurrently with E’s hiring. For example, if Hospital B hired E with the understanding that it would also contract with Company
X for billing and collection services, would both contracts be covered by the initial contract exception if they were entered into on the same day? In the same week?

To clarify this point, we suggest adding the following sentence at the end of Example 6: “If Hospital B contemplated contracting with Company X at the time it hired E, and entered into the contract with Company X within one week of hiring E, then both E and Company X would be protected by the initial contract exception.”

**Temp. Reg. § 53.4958-4T(a)(4)---Benefits Provided to Donors**

The temporary regulations provide that one of the factors tending to show that a person has substantial influence is that “the person is a substantial contributor to the organization” taking into account only contributions in the current year and the preceding four years. Temp. Reg. § 53.4958-3T(e)(2)(ii). Major donors may therefore be disqualified persons.

The temporary regulations provide two forms of relief to major donors. First, preferential treatment “offered to all other donors making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions” is a fact tending to show that the donor does not have substantial influence and is therefore not a disqualified person. Temp. Reg. § 53.4958-3T(e)(3)(v). Second, benefits provided to a donor who is a disqualified person are disregarded if any non-disqualified person making a contribution above a specified amount is offered substantially the same benefit and a significant number of non-disqualified persons make a contribution of at least that amount. Temp. Reg. § 53.4958-4T(a)(4)(iii).
These relief provisions are appropriate and should be retained. However, they are limited to situations where the donation is part of a fundraising campaign. Many major contributions are made in isolation, not as part of an organized campaign.

Any benefit provided to a major donor should not be objectionable if the value of the benefit does not exceed the value of the donation and the donor treats the benefit as a quid pro quo that reduces the charitable income tax deduction arising from the donation. We thus recommend that the temporary regulations be modified to treat such quid pro quo benefits as economic benefits which are disregarded for purposes of section 4958 by adding a new subparagraph (vi) at the end of Temp. Reg. § 53.4958-4T(a)(4) that would read as follows: “(vi) Quid pro quo contributions. Any benefit received by a donor that is less than the donor’s contribution and is taken into account by the donor as a reduction of the donor’s charitable income tax deduction.”

**Temp. Reg. § 53.4958-4T(b)(2) — Timing of Reasonableness Determination**

The temporary regulations provide that the reasonableness of a fixed payment is determined when the parties enter into the contract providing for the fixed payment. Temp. Reg. § 53.4958-4T(b)(2)(i). This appears to be true without regard to whether the fixed payment is subject to a substantial risk of forfeiture. This is unlike the rule for determining the “date of occurrence” of an excess benefit transaction, where a substantial risk of forfeiture will delay the date of occurrence until there is no longer a substantial risk of forfeiture. Temp. Reg. § 53.4958-1T(e)(2).

For clarity it would be helpful to state specifically that the existence of a substantial risk of forfeiture does not affect the timing of the determination of reasonableness for
a fixed payment. We suggest adding a clause at the end of the first sentence of Temp. Reg. § 53.4958-4T(b)(2)(i) that would read as follows: “without regard to whether the fixed payment is subject to a substantial risk of forfeiture.”

The reasonableness of a non-fixed payment is made as of the date of payment. *Id.* It would seem that a substantial risk of forfeiture should be ignored for this purpose as well. If that is the intention, then instead of inserting the above clause, we suggest adding a new sentence at the end of Temp. Reg. § 53.4958-4T(b)(2)(i) that would read as follows: “The timing of the determination of reasonableness is made at the time that the right to payment is fixed regardless of the existence of a substantial risk of forfeiture with respect to the payment.”

**Comments on Temp Reg. § 53.4958-6T**

*Temp. Reg. § 53-4958-6T(c)(1)(i)(C) — Definition of “Authorized Body”*

The temporary regulations provide an organization’s board of directors with broad authority to delegate its responsibilities as an “authorized body” in fulfilling the requirements of the rebuttable presumption. *Temp. Reg. § 53.4958-6T(c)(1)(i)(C).* The two restraints on delegation are that (1) the board of directors must specify procedures to be followed in approving a transaction and (2) the delegation must be permitted under state law.

In the health-care context it often is efficient to centralize compensation review for several commonly controlled organizations in one of the organizations. Such centralization reduces duplication of efforts and responsibilities across separate organizations and appears to be authorized by the broad language of *Temp. Reg. § 53.4958-6T(c)(1)(i)(C).* However, because large numbers of physicians and other professionals in a health-care system might be considered
disqualified persons, it would be helpful for the regulations to include specific guidance on this point. We suggest adding the following language prior to the period at the end of Temp. Reg. § 53.4958-6T(c)(1)(i)(C): “, including an authorized body of a parent organization or an authorized body of a commonly controlled organization.”

**Temp. Reg. § 53-4958-6T(c)(2)(iv), Example 4—Compensation studies**

In the above referenced example, the temporary regulations conclude that, if a tax-exempt hospital has obtained a customized compensation study, the hospital may, in the absence of evidence that market conditions have changed, rely on that study in the immediately following year without commissioning a new study.

Markets change constantly; therefore it would be appropriate to insert the word “materially” before the word “changed” in the first sentence of the example. In addition, we believe that the example in the temporary regulations would be more useful if it included a longer period, such as three years. Several widely circulated compensation studies are not published annually. Given that total compensation levels seldom decrease, we believe a longer period of reliance on such studies would be appropriate.

**Comments on Temp. Reg. § 53.4958-7T**

**Temp Reg. § 53.4958-7T(b)(4)—Correction by return of specific property**

The temporary regulations provide that, with the agreement of the applicable tax-exempt organization, a disqualified person may correct a transaction by returning specific property that was the subject of an excess benefit transaction. However, the applicable tax-exempt organization cannot force the disqualified person to correct the transaction in this
manner. If the subject property, such as a painting, has appreciated in value since the excess benefit transaction, the temporary regulations give the disqualified person an incentive to sell the property rather than returning it to the tax-exempt organization because the property is valued, for correction purposes, at the lesser of its value at the time of the excess benefit transaction or the time of its return. *See* Temp. Reg. § 53.4958-7T(b)(4)(i). The temporary regulations do, however, provide that if the property in question has decreased in value, the disqualified person must make a cash payment to make the tax-exempt organization whole. *See* Temp. Reg. § 53.4958-7T(b)(4)(ii).

The regulations should be modified to require, if the tax-exempt organization so desires, the return of the specific property in question. Section 4958(f)(6) defines “correction” as “undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.” This definition is similar to the Code definition with respect to the correction of self-dealing transactions under section 4941. Section 4941(e)(3) requires “undoing the transaction to the extent possible, but in any case placing the private foundation in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.”

We believe that the “highest fiduciary standards” require the return of specific property if the tax-exempt organization desires. For example, suppose that a museum director, a disqualified person with respect to the museum, purchased a painting from the museum for less than its fair market value because the artist was not well known to the museum staff and the true value of the painting was known only by the museum director. Assume further that, after the transaction is discovered, but before it is corrected, the painting suddenly increased in value
because the artist acquired greater fame. Under the temporary regulations, the museum would **not** be entitled to a return of the painting without making an additional cash payment to the disqualified person to cover the difference between its current market value and the fair market value at the time of the excess benefit transaction. In such a case, the temporary regulations permit the disqualified person to profit from the excess benefit transaction. We believe that, in order to prevent the tax-exempt organization from being placed in a place worse than it would otherwise be if the disqualified person were dealing under the highest fiduciary standards, the section 4941 correction standards should also be applied to section 4958. These standards generally require the rescission of the transaction where possible. *See* Treas. Reg. § 53.4941(e)-1(c)(2)(i).

*Temp. Reg. § 53.4958-7T(e)—Relationship of disqualified person and successor organization.*

The temporary regulations provide that, if the applicable tax-exempt organization that was part of an excess benefit transaction no longer exists at the time of the correction, any necessary payments must be made to an organization described in the dissolution clause of the applicable tax-exempt organization’s governing documents. The temporary regulations prohibit a distributee organization from being “related to” the disqualified person.

We believe the “related to” standard is insufficiently precise. Many tax-exempt organizations have dissolution clauses that permit the distribution of their assets upon dissolution to any organization then classified as a section 501(c)(3) organization. It is not clear that, for example, a private foundation controlled by a corporation in which the disqualified person is a shareholder would meet the “related to” standard. Similarly, it is not clear that a public charity
establishing a donor-advised fund with the proceeds of the correction amount would be classified as “related to” the disqualified person.

The temporary regulations should be modified in two respects. First of all, the regulations should clarify that for purposes of the correction, an organization will not be treated as “related to” the disqualified person if the organization is described in section 170(b)(1)(A)(vi) and if the disqualified person (or any person who is a disqualified person by virtue of a relationship to the disqualified person making the correction) has no authority to make or recommend grants by the organization receiving the correction payment.

If the recipient organization does not meet this safe harbor standard, the regulations should provide that, in situations where the tax-exempt organization has ceased to exist, the organization receiving the correction payment must be selected with the consent of an appropriate state official, such as a state Attorney General, with supervisory power over the dissolved tax-exempt organization, or by a court of competent jurisdiction. The participation of such an official or a court will prevent abuse by the disqualified person and also assure that any state law standards on the distribution of assets of the dissolved tax-exempt organization are satisfied.

Comments on Temp. Reg. § 53.4958-8T

Temp. Reg. § 53.4958-8T(a)—Factors leading to revocation of exemption

The preamble to the temporary regulations notes that “[t]he IRS intends to exercise its administrative discretion in enforcing the requirements of sections 4958, 501(c)(3) and 501(c)(4) in accordance with the direction given in the legislative history” of section 4958.
The legislative history acknowledges that revocation of exemption may be imposed in addition to intermediate sanctions, but that revocation would not normally be imposed if the excess benefits do not rise to a level sufficient to call into question the organization’s functioning as a tax-exempt organization. The preamble further states that “[t]he IRS will publish guidance concerning the factors that it will consider in exercising its discretion as it gains more experience administering the section 4958 regime.” 66 Fed. Reg. at 2155.

In the Proposed Regulations Comments, we suggested that the regulations provide a list of factors to be taken into account in determining whether revocation of exemption would be appropriate. We continue to believe that such guidance would be useful for exempt organizations and examining agents. As the preamble suggests, it may not be possible at this point to anticipate all the factors that should be taken into account. However, we submit that this does not justify failing to provide any guidance at all on this subject in the final regulations themselves, which often will be referenced by exempt organizations and examining agents without the accompanying preamble language. Thus, we suggest that the following be added to the regulations:

In making a determination as to whether to revoke the exemption of an applicable tax-exempt organization that has been involved in an excess benefit transaction, the Service will consider the following factors:

1. The number, frequency, size, extent, willfulness and flagrancy of the excess benefit transactions;

2. The adoption of procedures and safeguards by the organization, whether before or after the occurrence of any excess benefit transaction, that are reasonably calculated and sufficient to prevent the occurrence of future excess benefit transactions;
(3) The likelihood that excess benefit transactions involving the organization may recur with or without the adoption of such procedures and safeguards;

(4) The extent and success of the organization’s regular and ongoing programs and activities that substantially further charitable, educational, religious or other tax-exempt purposes;

(5) The impact on the ability of the organization to further charitable, educational, religious or other tax-exempt purposes if the organization’s tax-exempt status is revoked;

(6) The proportionality of the consequences of revocation of tax-exempt status to excess benefit transactions;

(7) The degree of oversight of the organization provided or to be provided by state and local governmental authorities, recognized independent nonprofit accreditation agencies, recognized independent nonprofit national governing bodies or associations or the like; and

(8) All other relevant facts and circumstances.

**Conclusion**

The temporary regulations continue the constructive process to provide administrable guidance with respect to section 4958 and provide welcome clarification. We would welcome the opportunity to meet with appropriate representatives of the Service and Treasury to discuss these suggestions in person and to testify at any public hearings with respect to the regulations.