I am Carolyn M. Osteen of Ropes & Gray in Boston, Massachusetts. My practice primarily involves representation of colleges, universities, hospitals and other tax-exempt organizations. I appear before you today as a private individual. I serve as the Chair of the Exempt Organizations Committee of the American Bar Association, Section of Taxation; however, this testimony is not presented on behalf of the Section of Taxation or the American Bar Association and should not be construed as representing the policy of the Association. I commend the Internal Revenue Service and Department of Treasury for their extraordinary efforts in developing and issuing these regulations. I appreciate the time and effort devoted to performing this important function.

These comments concern proposed regulations promulgated under section 4958 of the Code to explicate the new excise taxes on excess benefits transactions. They summarize the comments submitted on behalf of the Committee which point out that a number of areas remain unclear in spite of the extraordinary efforts made by representatives of Treasury and the Internal Revenue Service to put together comprehensive and complete guidance. These regulations will have a considerable impact on the approximately 525,000 charitable organizations which according to recent data, the Internal Revenue Service recognizes as exempt under section 501(c)(3).

The regulations need to be clarified in a number of areas including the timing of the "transaction" in order to administer it in the compensation context, in particular with respect to deferred compensation, who is a disqualified person, the proper structure of revenue sharing transactions, the make up of the independent board of trustee committee or group to approve the compensation arrangement.

As noted in the Committee comments following the adoption of the original legislation, the enactment of section 4958 has introduced a complex new penalty structure applicable to more than half a million organizations and has substantially complicated the day-to-day lives of the managers and boards of those organizations.

Comments on Prop. Reg. '53.4958-1

A. Correction

The proposed regulations appropriately state the legal standard for what is required for "correction" of an excess benefit transaction indicating that correction may occur by either repayment of money, plus interest, equal to the amount of the excess benefit, or by the return of property to the exempt organization. In addition, the regulations quite helpfully indicate that termination of employment or independent
contractor relationships is not necessarily required, although the organization and the disqualified person may need to modify such relationships.

Although the existing proposed regulations are helpful, we believe that the regulations should specify that the exempt organization, and not the disqualified person, has the discretionary power to determine the form that the correction will take. The proposed regulations do not currently give the exempt organization the authority to impose its preference on the disqualified person in determining the form of correction.

In order to assure that the applicable tax-exempt organization has the ability to enforce its preferences for correction of an excess benefit transaction involving transfers of property, we recommend the addition of language stating that correction may be accomplished, in certain circumstances, by returning property to the organization and taking any additional steps necessary to make the organization whole as determined by the organization.

B. Reliance on Advice of Counsel

Prop. Reg. section 53.4958-1(d)(7) provides that, for purposes of the tax on organization managers imposed by section 4958(a)(2), an organization manager's participation in a transaction is not "knowing" or "willful" and is ordinarily "due to reasonable cause" if the organization manager, after full disclosure of the facts to legal counsel, relies on a reasoned written legal opinion of counsel that the transaction is not an excess benefit transaction.

We recommend that the final regulations add a provision permitting reliance on advice of professional experts on non-legal matters. We further recommend that parallel provisions be added to Treas. Reg. sections 53.4941(a)-1(b) and 53.4945-1(a)(2). Most excess benefit transactions involve two questions: valuation (the "valuation component") and compliance with applicable legal standards and procedures (the "procedural component"). The proposed regulations provide that an organization manager's participation in a transaction will not be willful or knowing, and that such manager will act with reasonable cause, if he or she relies upon an opinion addressing the procedural component. However, nothing in the proposed regulations provides a similar safe-harbor for opinions addressing the valuation component.

We believe that an organization manager should be entitled to the same protection if either an opinion addressing the valuation component or the procedural component is obtained, even if that opinion is later determined by the Internal Revenue Service to be erroneous.

The valuation component in most transactions is likely to be within the competence of a qualified appraiser of goods or services, rather than within the competence of an attorney. On the other hand, the procedural component is more likely to be within the competence of an attorney, rather than an appraiser. In some transactions, a well-advised organization manager may find it necessary to obtain the counsel of both kinds of expert. In other transactions, however, due to the particular experience of the organization manager or the availability of published data regarding compensation, the services of only one kind of professional may be required. In most cases, a written legal opinion is likely to disclaim any opinion on valuation.

For purposes of consistency, we also recommend that parallel provisions be added as Treas. Reg. sections 53.4941(a)-1(b)(7) and 53.4945-1(a)(2)(vii).

C. Timing of Excess Benefit "Transaction"

The proposed regulations indicate that "an excess benefit transaction occurs on the date on which the disqualified person receives the economic benefit from the applicable tax-exempt organization for federal income tax purposes." The proposed regulations go on to provide a special rule for deferred compensation payments, stating that "the transaction occurs on the date the deferred compensation is earned and vested."
The timing of the occurrence of the excess benefit "transaction" is important for two purposes. First of all, it is necessary to determine whether the individual involved is a disqualified person at the time the "transaction" occurs. If the individual is not a disqualified person at the time of the "transaction," then no tax is imposed. In addition, it is important to determine the timing of the "transaction" for purposes of assessment and payment of tax and correction. Because the proposed regulations appropriately adopt existing statute of limitations principles and condition the running of the statute upon the timing of return filing (see Prop. Reg. section 53.4958-1(f)), the timing of the occurrence of a "transaction" within the taxable year is not of substantial importance for statute of limitations and assessment rules. However, the timing of the transaction may be vitally important for purposes of determining the appropriate corrective action.

**Deferred compensation.** We believe that the specific rule provided for deferred compensation is an appropriate rule. As we understand the operation of the rule, a disqualified person would be subject to tax at the first time upon which deferred compensation is both earned and vested. Deferring the timing of the excess benefit transaction until the deferred compensation is actually payable could result in situations where excessive deferred compensation is never subject to excess benefit taxes because the recipient of the compensation is not a disqualified person at the time it is ultimately paid.

We believe, however, that the proposed regulations would be improved by making it clear that, in this context, the timing of the excess benefit "transaction" has nothing to do with the timing of the determination of reasonableness of the deferred compensation. Rather, the transaction occurs on the date the deferred compensation is earned and vested, although reasonableness is determined by reference to all elements of the compensation arrangement.

**Property transfers.** We believe the rule of the proposed regulations is also appropriate with respect to transactions involving the transfer of property between a disqualified person and an applicable tax-exempt organization. As we understand the application of the proposed regulations, the timing of the transaction would be the date on which the transfer of property occurs.

**Compensation.** In the compensation context, there are a number of points in the relationship between a disqualified person and the applicable tax-exempt organization which could be thought of as the relevant "transaction"—the completion of contractual negotiations regarding employment, the payment of compensation, the provision of services by the disqualified person, or some period encompassing both the timing of the organization's payments and the provision of services by a disqualified person. In the committee report accompanying section 4958, the "transaction" for purposes of application of the presumption of reasonableness appears to have been thought of as the initial approval of the compensation, which otherwise could not be documented contemporaneously. The proposed regulations appear to focus only on the time of payment as the "transaction" in the compensation context.

The proposed regulations fail to provide sufficient certainty with respect to the timing of the receipt of excess benefit transactions with respect to compensation. Suppose, for example, that the chief executive officer of an applicable tax-exempt organization is contractually entitled to a salary of $500,000 per year plus an annual bonus, payable on the last day of the organization's fiscal year, of up to 20% of salary, as determined by the organization's board of directors. Assume further that the board awards the officer a bonus of $100,000, and that it is subsequently determined that the maximum reasonable compensation for the officer is $500,000 per year.

Is some portion of the disqualified person's monthly compensation subject to tax because annual compensation is excessive, or does the receipt of the excess benefit occur only when the amounts received by the disqualified person during the year begin to exceed the maximum compensation which is reasonable? When does the transaction occur if the excess benefit occurs not because the disqualified person's salary, as originally determined, was excessive but because the disqualified person fails to perform pursuant to the contract? The proposed regulations do not answer these questions, and they could be of vital importance to disqualified persons attempting to correct excess benefit transactions.
Another difficulty with the rule for the timing of the relevant transaction in the proposed regulations is that it appears to sweep in dealings with individuals that should not be covered by the statute. For example, suppose an applicable tax-exempt organization enters into a contract to hire a new chief executive officer. Assume further that the individual has no preexisting relationship with the organization but is determined by the organization’s board of directors to be the best qualified candidate for the job and is hired pursuant to a five-year employment contract.

The committee report with respect to section 4958 clearly indicates that Congress intended to impose penalty excise taxes only on transactions with certain insiders that result in private inurement. An individual negotiating an employment contract with an organization for the first time is not an insider falling within the scope of the inurement proscription. By treating the relevant transaction as the time of payment, after the individual becomes a disqualified person, the proposed regulations appear to be inconsistent with congressional intent in that they impose taxes on arrangements which do not violate the present law inurement prohibition.

We believe that both of these issues should be dealt with by modifications to the proposed regulations regarding the timing of excess benefit transactions. We believe the entry into a compensation relationship should be treated as the applicable "transaction," at least for the first one to two years of any arrangement for compensation for a person who was not previously a disqualified person with respect to the organization. To prevent abuse, however, signing bonuses should not be excluded by this rule, but should be allocated over the term of the contract. A special rule, fixing the timing of the "transaction" at some arbitrary point, such as the end of the taxable year, should be adopted to provide an administrable rule fixing the time of the transaction for excessive compensation received in various payments throughout the taxable year.

Comments on Prop. Reg. '53.4958-2'

A. Which Organizations are Subject to Intermediate Sanctions

The proposed regulations provide reasonable and appropriate rules for determining which organizations will be considered applicable tax-exempt organizations. In an effort to make sense of the potentially ambiguous statutory definition which looks to organizations that would be described in sections 501(c)(3) or (4) rather than organizations that have received an exemption under those provisions (or which, like churches, are entitled to exemption without applying) the proposed regulations adopt the following tests:

- In the case of section 501(c)(3) organizations, the proposed regulations provide that an organization must meet the requirements of section 508, including any applicable exceptions provided by that section.

- In the case of section 501(c)(4) organizations, the proposed regulations provide that an organization must have received exemption under that section, filed a request for such exemption, filed Form 990 as a section 501(c)(4) organization, or provision.

B. Foreign Organizations - Prop. Reg. '53.4958-2(b)

Clarification is needed as to the treatment of foreign charitable organizations that are not required to file for exemption because they receive substantially all their support from non-United States sources. Such organizations are often treated as foreign equivalents of section 501(c)(3) organizations by United States private foundation grantmakers, on the basis of the determinations that such organizations would meet the requirements for exemption under section 501(c)(3). Treas. Reg. section 1.508-1(a)(2)(vi) provides that section 508 does not apply to such foreign organizations if they are described in section 4948(b), which excludes foreign charities that receive substantially all their support, other than gross investment income, from sources outside the United States.
The proposed regulations adopt an approach that is intended to be consistent with section 508, providing explicitly that foreign organizations which are not subject to section 508 are not Aapplicable tax-exempt organizations @ for purposes of section 4958. The exclusion of foreign charities from the application of section 4958 is not only legally sound but a sensible recognition that the Internal Revenue Service should not attempt an extraterritorial application of its rules to foreign charities who have minimal contacts with the United States.

We assume that the foreign charities intended to be excluded from the definition of Aapplicable tax-exempt organizations @ would include those that have, at one time, sought and received exemption under section 501(c)(3), even though they were not subject to section 508 or section 4948 and thus were not required to obtain such exemption. We recommend that the proposed regulations provide explicitly that these organizations are not Aapplicable tax-exempt organizations @ for purposes of the intermediate sanctions rules.

Comments on Prop. Reg. ' 53.4958-3 - Disqualified Person Status

Section 4958(f)(1) defines the term "disqualified person" with respect to any excess benefit transaction as any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization. In addition, the term "disqualified person" is defined to include members of the family of a disqualified person as well as "35%-controlled" corporations, partnerships, trusts, and estates.

A. Persons having substantial influence

Prop. Reg. section 53.4958-3(c)(1) defines a person who has "substantial influence" as "any individual serving on the governing body of an applicable tax-exempt organization who is entitled to vote on matters over which the governing body has authority." We believe that this provision could lead to confusion with respect to membership organizations.

Although most states provide that a not for profit corporation's affairs are managed by its directors, some organizations provide, in their articles of incorporation or bylaws, for various decisions to be made by the corporation's members. Members generally are permitted only to vote for officers or directors and with respect to various major structural or policy matters.

We believe that final regulations should make it clear that, except in the case of a "member" of an organization who otherwise serves on the organization's governing body, the term "any individual serving on the governing body" does not include a "member" of an organization (or a person with similar attributes under local law) whose voting rights are limited to the election of officers, directors, or trustees and approving such fundamental organizational transactions as merger, liquidation, or dissolution.

We also believe it appropriate that an individual who serves on an organization's governing body be deemed to have "substantial influence" by reason of having any voting authority. Accordingly, we recommend that the word "any" be inserted before the word "matters" to clarify that an individual serving on the governing body of such an organization who has any voting authority has substantial influence.

Prop. Reg. section 53.4958-3(c)(2) determines whether certain organizational officers have "substantial influence" by examining whether any such individual "has or shares ultimate responsibility" for implementing certain decisions of an applicable tax-exempt organization. In many organizations, an individual may hold a position the title of which implies that such individual shares the ultimate responsibility for implementing a certain type of decision, when in actual fact that individual's share of influence is not "substantial." For example, the office of "immediate past president" or "honorary chair" may imply varying degrees of shared ultimate responsibility when, in fact, such shared responsibility often does not exist.
We believe only those individuals who bear the specific titles of president, chief executive officer, and chief operating officer, or their equivalents, should be treated as "disqualified persons" under paragraph (c)(2). Others who may be viewed as "sharing" ultimate responsibility for certain decisions should have their "disqualified person status" determined under the facts and circumstances test of Prop. Reg. section 53.4958-3(e). By eliminating the "shares responsibility" language, only an individual who "has" ultimate responsibility for implementing certain decisions will be deemed to have substantial influence. Accordingly, we recommend that the first sentence state that the category "includes any individual who serves as" the president, CEO or COO of the organization, thereby excluding individuals who share these positions "with others."

Since the language in this section mirrors the language in Prop. Reg. section 53.4958-3(c)(2) discussed directly above, we recommend that the same changes suggested above with respect to Prop. Reg. section 53.4958-3(c)(2) be made consistently with regard to treasurers and chief financial officers. As stated above, we think that individuals with shared responsibility should be tested for substantial influence under the facts and circumstances test of Prop. Reg. section 53-4958-3(e). Accordingly, we recommend that the first sentence state that the category "includes any individual who serves as treasurer or chief financial officer of the organization." We further recommend that the second sentence state that the category includes those who serve as a treasurer or chief financial officer, regardless of title, "if that individual has ultimate responsibility for managing the organization's financial assets."

Additionally, we recommend that the second sentence of Prop. Reg. section 53.4958-3(c)(3) end after the word "assets" in order to eliminate the sentence that would attribute substantial influence by virtue of possessing (or sharing) authority to sign drafts or authorize electronic transfers to a person. Such an individual who merely serves as an accommodating party likely does not have "substantial influence" in an organization. Rather, we believe that this type of factor should be taken into account for testing substantial influence under the facts and circumstances test of Prop. Reg. section 53.4958-3(e).

B. Persons Deemed Not to Have Substantial Influence

1. Applicable tax-exempt organization described in section 501(c)(3).

We believe that the clear intent of Congress in enacting section 4958 and the plain language of that section is to impose economic sanctions on those persons involved in a violation of the traditional private inurement proscription set forth in section 501(c)(3). We do not believe that Congress intended or that the language of section 4958 supports extending the reach of the sanctions imposed by section 4958 to circumstances and situations that result in the failure to satisfy other elements required of an organization described in section 501(c)(3).

Accordingly, we believe that Prop. Reg. section 53.4958-3(d)(1) should be broadened to protect transactions with any organization described in section 501(c)(3).

2. Employees receiving economic benefits of less than specified amount in a taxable year.

The first sentence of Prop. Reg. section 53.4958-3(d)(2)(i) notes that a person deemed not to have substantial influence "includes, for the taxable year in which benefits are provided," certain employees who receive economic benefits from an applicable tax-exempt organization of less than a specified amount.

Prop. Reg. section 53.4958-3(d)(2)(i) provides that a person who receives economic benefits from an organization of less than the amount of compensation referenced for a highly compensated employee in section 414(q)(1)(B)(i) and satisfies certain other conditions is deemed not to be a disqualified person. We recommend that the final regulations make it clear that this category of person is not limited to employees of the organization, but rather includes employees of affiliates as well as independent contractors who receive in exchange for services no more than the amount of compensation referenced in section 414(q)(1)(B)(i). Further, we recommend that this section be expanded to clarify that the section
414(q)(1)(B)(i) cut-off is an absolute dollar figure and that the compensation paid to part-time workers does not have to be annualized in determining whether the exclusionary requirement has been met.

Prop. Reg. section 53.4958-3(d)(2)(i)(C) provides that a person receiving economic benefits of less than a specified amount will be deemed not to have substantial influence provided that such person is "not a substantial contributor to the organization within the meaning of section 507(d)(2)." Section 507(d)(2)(B)(iv) provides that an individual who is a substantial contributor as of a certain date "will remain a substantial contributor for all subsequent periods." Section 4958, however, focuses on whether an individual is a disqualified person with respect to an "excess benefit transaction" for only a five-year look-back period ending on the date of the "excess benefit transaction." Therefore, incorporating by reference the section 507(d)(2) definition of a "substantial contributor" into section 4958 results in a look-back period that is potentially greater than five years. We recommend that an additional sentence be added to Prop. Reg. section 53.4958-3(d)(2)(i)(C) be amended to make it clear that only the five year look-back period governs.

We recommend that the definition of a substantial contributor for purposes of Prop. Reg. section 53.4958-3(c)(2)(ii) also be modified by adding the same sentence referenced above with regard to Prop. Reg. section 53.4958-3(d)(2)(i)(C) to recognize that the look-back period for determining whether a person is a "disqualified person" is limited to a five-year period.

3. Facts and Circumstances Tending to Show Substantial Influence.

Prop. Reg. section 53.4958-3(e)(2)(iii) provides that if a "person's compensation is based on revenues derived from activities of the organization that the person controls," this fact tends to show that such person has "substantial influence" over the affairs of such organization. It is common practice in the health care industry for physicians to have compensation agreements based, in whole or in part, on economic productivity. As currently written, Prop. Reg. section 53.4958-3(e)(2)(iii) indicates that such a compensation agreement would tend to show that a physician (who is typically in control of his or her activities) is a disqualified person. The applicable committee report to section 4958 seems to indicate that a higher threshold should apply for concluding that a physician/employee is a disqualified person. We believe that this is such an important issue to the tax-exempt healthcare industry that this subsection should be deleted in its entirety to be consistent with the committee report and to recognize that this type of compensation arrangement is common in the tax-exempt healthcare industry. At a minimum, we believe that final regulations should make it clear that a compensation arrangement based on an employee's productivity does not tend to show that such person has substantial influence absent other facts and circumstances.

Prop. Reg. section 53.4958-3(e)(2)(iv) states that the fact that a person has authority to determine a "significant" portion of the organization's capital expenditures tends to show that such person has "substantial influence" over the affairs of the organization. Rather than the word "significant," which is ambiguous in the tax law sense, we recommend that the word "substantial" be used in its stead. In tax law, the word "substantial" is a term that is better understood and quantifiable. For example, something may be "significant" in tax law, but still may not be "substantial" enough to raise tax liability concerns.

As it currently reads, Prop. Reg. section 53.4958-3(e)(2)(v) seems to indicate that the fact that an individual has some type of "managerial authority" tends to show that such individual has "substantial influence" over the affairs of the organization. There are many situations, however, where an individual with "managerial authority" does not have "substantial influence" in the organization.

4. Facts and circumstances tending to show no substantial influence.

Prop. Reg. section 53.4958-3(e)(3) identifies facts and circumstances tending to show that a person does not have "substantial influence." In addition to the persons listed in (3)(i)-(iii), a new subsection (iv)
should be added to indicate that the fact that an individual is subordinate to another individual tends to show that such individual does not have "substantial influence" and, thus, is not a disqualified person.

Comments on Prop. Reg. ' 53.4958-4

Prop. Reg. section 53.4958-4 follows the provisions of section 4958(c)(1), which describes transactions in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit.

Broadly speaking, excess benefit transactions governed by Prop. Reg. section 53.4958-4 involve compensation arrangements and non-gratuitous property transactions between an applicable tax-exempt organization and a disqualified person. In determining whether the economic benefit conferred on the disqualified person is excessive under Prop. Reg. section 53.4958-4, a compensation arrangement is tested for reasonableness and a payment for property is tested for fair market value. To the extent that the compensation is unreasonable or the payment for property is other than fair market value, the excise taxes that may be imposed are based on a percentage of the excess benefit amount.

A. Is the economic benefit attributable to the applicable tax-exempt organization?

Under the proposed regulations, an economic benefit will be attributed to an applicable tax-exempt organization if the source of the benefit is one or more taxable or non-taxable entities owned, controlled by, or affiliated with the organization. Prop. Reg. ' 53.4958-4(a)(2), 53.4958-4(b)(3)(ii)(E). The proposed regulations also state that a benefit may be provided indirectly through the use of another entity and cite as an example a situation in which an applicable tax-exempt organization causes a taxable subsidiary to pay excessive compensation to a disqualified person. Prop. Reg. ' 53.4958-4(a)(2).

The proposed regulations neither define ownership, control, or affiliation for purposes of the attribution rule nor clarify what constitutes causation for purposes of attributing a benefit to an applicable tax-exempt organization. For example, under what circumstances would the salary of the medical director of an ambulatory surgery center in which a tax-exempt hospital had a 30 percent interest be attributable to the hospital, assuming the medical director was also a disqualified person with respect to the hospital?

The indirect excess benefit transaction rules apply to legally controlled, as well as to legally unrelated, intermediaries by treating either control or earmarking as evidence that an organization is an intermediary with respect to a particular indirect excess benefit transaction.

B. If the economic benefit constitutes compensation, is the compensation reasonable? When is the reasonableness determination made with respect to contingent and deferred compensation?

The proposed regulations provide that, for purposes of determining reasonableness, the circumstances existing at the time the contract for services is made are considered unless the facts are insufficient to make the determination. In that event, the reasonableness determination is delayed until the facts and circumstances are sufficient, up to and including the time of payment. Prop. Reg. ' 53.4958-4(b)(3). In that event also, establishment of the rebuttable presumption will be delayed because the presumption cannot be established until there are sufficient facts to determine reasonableness. Prop. Reg. ' 53.4958-6(e).

The text of the proposed regulations does not provide any guidance as to what constitutes sufficient facts and circumstances for determining the reasonableness of contingent and deferred compensation arrangements, and the two examples are singularly unhelpful.

Contingent compensation issues. The proposed regulations appear to take a wait and see approach with respect to contingent compensation arrangements that constitutes a departure from the rule under section 162 which states that the time for determining the reasonableness of contingent compensation is the same as for flat compensation when the contract is entered into, provided that: (1) the contract is
negotiated at arm's-length, (2) the contract is entered into before the services are rendered, and (3) the compensation is solely for services. Treas. Reg. ' 1.162-7(b)(2). The section 162 regulations also state that the fact that actual compensation under the contract exceeds an amount that would otherwise be considered reasonable under all the facts and circumstances will not bar deduction. Id.

Under the proposed regulations, however, it appears that a contingent compensation arrangement that could pass the section 162 reasonableness test at the time it was awarded might have to be tested separately in the later year when the precise amount of the compensation was finally determined. This approach is also inconsistent with the case law and the existing rulings that recognize that contingent compensation arrangements can be tested as of the time they are entered into.

Deferred compensation. The proposed regulations appear to assume that, as a general matter, amounts payable as deferred compensation cannot be reasonably estimated at the time the arrangement is entered into. That assumption is largely incorrect. Tax-exempt as well as taxable organizations routinely consult compensation experts and/or rely on internally and externally generated data for purposes of determining the reasonableness of a wide variety of deferred compensation arrangements before they are finally adopted. As is the case with contingent compensation arrangements, the rules of section 162 should apply to deferred compensation as well as to contingent compensation arrangements. The fact that the amounts may not be currently reportable as income under sections 83 or 457 does not mean that the reasonableness determination cannot be made when the arrangement is made. If adopted, the await and see @ approach in the proposed regulations will cause substantial and unnecessary administrative problems for both the Service and applicable tax-exempt organizations.

Unless the approach of section 162 is adopted, some of the questions raised by this type of arrangement will include:

• To the extent that the amounts payable under the entire package cannot be determined fully when the contract is made, will the reasonableness of each item in the package have to be determined separately as the items vest in future years?

• Will the procedural requirements to establish the rebuttable presumption have to be met each year with respect to each payment to each executive entitled to benefits under the package?

• Will the reasonableness of the severance pay element of the package be determined on the basis of the value of the services to the organization at the time the compensation package is adopted or at the time of termination? If the severance payments are consideration for a buy-out of an existing employment contract, will the value and the vesting of the severance pay be determined under section 83?

• If the individual was a disqualified person when the compensation package was adopted but is not one when at least some items are payable, will the arrangement still have to be tested for reasonableness under Prop. Reg. section 53.4958-4 at the time payment is to be made?

• Will earnings that accrue during the interim between the time a compensation package is adopted and the time items become payable be treated as part of the compensation to be tested for reasonableness? (If interest rates or stock market prices increase to unexpected levels during the interim, treating earnings as compensation could disqualify the compensation as reasonable for reasons that were not foreseeable at the time the compensation package was awarded to the disqualified person.)

The final regulations should explicitly recognize that the reasonableness of contingent and deferred compensation arrangements can typically be determined at the time the arrangements are entered into based on factors for determining reasonableness that are well established by case law and by the Service's own rulings. This "up-front" testing approach can and should be applied to all such compensation arrangements whether the individual is already a disqualified person or will become one by reason of the
arrangement. The adoption of such a principle is in no way inconsistent with the rule in Prop. Reg. section 53.4958-1(e) that an excess benefit transaction does not occur until the earlier of when the benefit is vested or is paid.

C. If the economic benefit constitutes compensation, is the compensation reasonable? What items should be treated as compensation?

In determining reasonableness, all forms of cash and non-cash compensation must be considered, including salary, fees, bonuses, deferred compensation earned and vested (whether or not funded), premiums for liability or other insurance coverage, severance payments, health and welfare benefits, fringe benefits (except those described in sections 132(d) and (e)), expense reimbursements or foregone interest on loans that the recipient must report as income on his or her separate income tax returns, and premiums paid for insurance coverage. Prop. Reg. ' 53.4958-4(b)(3)(ii). If deferred compensation is paid for services performed in multiple years, and the right to the deferred compensation vests in a later year, the deferred compensation is attributed to the earlier years in which the services were performed for purposes of determining reasonableness. Prop. Reg. ' 53.4958-4(b)(3)(ii)(B).

As a definitional issue, the proposed regulations do not make clear whether the term deferred compensation @ has the same meaning as under section 457, and whether it includes transfers of property for services performed that are subject to deferred reporting under section 83. The final regulations should provide that determinations as to what constitutes compensation (whether or not deferred), how it is valued and when it is reported should be governed by existing rules and authorities, such as those under sections 83, 162, 457, and 3121, with the time for testing and reporting tracking the disqualified person =s W-2 or 1099. In this regard, the final regulations should expressly provide that items of compensation need only be reported once for purposes of section 4958, i.e., when the item is awarded to the disqualified person (see discussion below). The final regulations should also recognize that some items of compensation that are payable in later years are difficult, if not impossible, to relate back to services performed in earlier years. These would include non-qualified deferred compensation plans and multi-year performance incentives.

In addition, the proposed regulations do not distinguish between benefits available to all employees of the organization and benefits that are available only to executives and other highly-compensated employees. The final regulations should provide that non-pension benefits of comparable value to which a substantial portion of the employee work force has access on equivalent terms should be disregarded for purposes of determining whether compensation is reasonable.

D. If the economic benefit constitutes compensation, is the compensation reasonable? Is the economic benefit compensation for performance of services or consideration for the transfer of property?

The proposed regulations generally define the term Acompensation @ to include all items paid for the performance of services. Prop. Reg. ' 53.4958-4(b)(3)(ii).

Many compensation packages include items that are not paid for the performance of services but rather for non-performance of services. For example, severance payments, which are specifically included in the definition of compensation, may be consideration for a buy-out or settlement of the employee =s rights under an existing personal services contract. Payments under a non-compete covenant generally constitute consideration for giving up the right to perform specified services for a specified period in a specified geographic area. In these cases, the payments are in respect of property rights, not compensation for services.

The final regulations should clarify that payments to service providers may sometimes be consideration for the transfer of property such as contract rights. This could be done through an example involving a payment for settlement of litigation, a buy-out of a non-compete or tenure contract, or a payment for waiver of Age Discrimination in Employment Act claims.
E. *If the economic benefit constitutes compensation, is the compensation reasonable? Does the benefit inure to the disqualified person or to the applicable tax-exempt organization?*

The proposed section 4958 regulations assume that certain types of payments by an applicable tax-exempt organization, such as payments of premiums for liability insurance (e.g., directors and officers insurance or medical malpractice coverage), constitute an economic benefit to the covered individual. Prop. Reg. ' 53.4958-4(b)(3)(ii)(C).

Other provisions of the Code recognize that such payments may be of substantially greater benefit to the applicable tax-exempt organization than to the individual, especially if the benefit is intended or required to facilitate the individual’s service to the organization. For example, the regulations under section 132(d) relating to working condition fringe benefits expressly provide that excludable benefits include liability insurance to indemnify volunteers of an exempt organization provided that the coverage relates to acts performed in the discharge of duties on behalf of the organization. Treas. Reg. ' 1.132-5(r)(ii).

The final regulations should clarify that, for purposes of section 4958, an economic benefit is one that primarily benefits the individual rather than the organization. Thus, items such as amounts paid to or on behalf of disqualified persons for lodging, meals and moving expenses for the convenience of the organization should not be treated as economic benefits received by those individuals. The final regulations should also clarify that the amount of premiums paid for liability or any other insurance coverage, as well as any payment of reimbursement by the organization of charges, expenses, and fees not covered ultimately by insurance, are not includable in compensation for purposes of determining reasonableness if the insurance coverage or reimbursement of uninsured expenses relate to services performed by the disqualified person on behalf of the organization.

F. *Is there clear and convincing evidence that the organization intended to treat the economic benefit as compensation?*

The proposed regulations require the organization to provide clear and convincing evidence that it intended to treat the benefit as compensation. Treas. Reg. ' 53.4958-4(c)(1). Such evidence includes reporting the benefit on W-2s or 1099s, or on the organization’s current year 990 (as initially filed or as amended). The requisite intent also can be established if the disqualified person reports the benefit on his or her current year 1040 (as initially filed or as amended). However, the reporting must occur prior to issuance of an audit notice for the year in question. Prop. Reg. ' 53.4958-4(c)(2)(ii).

We believe the proposed regulations generally provide appropriate and administrable guidance on establishing the requisite intent to provide compensation. However, we have two suggestions for improvement.

The final regulations should expressly provide that meeting the substantiation requirement as by a written contract evidencing intent to compensate, constitutes an acceptable *other method* for establishing intent to compensate. Moreover, if reporting an item on the applicable tax-exempt organization’s 990 is an acceptable method of proving intent, the 990 must be designed to achieve that result and guidance should be provided as to how to disclose the item (such as, for example, the compensation of a disqualified person who is not an officer or director or one of the five highest compensated employees) in such a way that the intent is established.

**Comments on Prop. Reg. ' 53.4958-5**

A. *General Approach Described in Section 53.4958-5(a) - Revenue Sharing*

We understand the basic approach taken in Prop. Reg. section 53.4958-5(a) to be as follows:

- A transaction is a "revenue-sharing transaction" if the benefit provided to the disqualified person is determined in whole or in part by the exempt organization's revenues;
Whether a revenue-sharing transaction constitutes an excess benefit transaction is determined without regard to the relationship between the benefit provided to the disqualified person and the value of any services or other consideration provided by the disqualified person;

Whether a revenue-sharing transaction constitutes an excess benefit transaction depends on whether the benefit provided to the disqualified person is proportional to the benefits enjoyed by the exempt organization in furtherance of its exempt purpose; and

The factors taken into consideration in determining whether a revenue-sharing transaction constitutes an excess benefit transaction include (a) the relationship between the benefit to the disqualified person and the quality and quantity of the disqualified person's services for the exempt organization, and (b) the ability of the disqualified person to control the relevant activities.

We recommend revisions to certain components of the approach so as to clarify the intended scope of Prop. Reg. section 53.4958-5(a).

First, we believe that the relationship between the benefit to the disqualified person and the quality and quantity of the disqualified person's services for the exempt organization is a factor that applies under section 4958(c)(1), but not under section 4958(c)(2). Relying on this relationship of benefit to services contradicts the clear statement that this determination is made "regardless of whether the economic benefit provided to the disqualified person exceeds the fair market value of the consideration provided in return . . . ."

Second, we believe that the concept of proportionality (between the benefit to the disqualified person and the furtherance of the exempt purpose) should be clarified. The final regulations should expand the description of this concept. Proportionality should be considered to exist when (a) the actions of a disqualified person that enhance the benefit provided to the disqualified person also enhance the exempt purposes of the exempt organization; and (b) the nature and extent of the benefit to the organization, throughout the term of the relationship with the disqualified person, remains consistent relative to the benefit provided to the disqualified person. Proportionality should not be considered to exist when a disqualified person is compensated for acting in a manner that enhances the disqualified person =s benefit without regard to, or to the detriment of, the exempt purposes of the exempt organization.

Third, we believe that section 4958(c)(1) should continue to apply to revenue-sharing arrangements that are compensatory in nature as to both (1) the requirement that compensation provided be reasonable in relation to the value of services provided and (2) the ability to qualify the revenue sharing transaction for the rebuttable presumption of reasonableness. The final regulations should provide that any revenue-sharing arrangement to which section 4958(c)(2) does not apply, or which is not treated as an excess benefit transaction under section 4958(c)(2), is subject to analysis under section 4958(c)(1).

Comments on Prop. Reg. ' 53.4958-6 - Rebuttable Presumption

The committee report with respect to section 4958 provides parties to a transaction subject to section 4958 a rebuttable presumption of reasonableness if the arrangement satisfies certain criteria. The proposed regulations provide helpful guidelines to establish a rebuttable presumption of reasonableness. The following comments and recommendations are designed to strengthen and clarify the guidance under Prop. Reg. section 53.4958-6.

A. Rebutting the Presumption

In the committee report with respect to section 4958, it was clear that "parties to a transaction are entitled to rely on a rebuttable presumption" under criteria described in section 53.4958-6(a) of the proposed regulations. The committee report further provides that if the criteria of section 53.4958-6(a) are satisfied,
the excise tax under section 4958 could only be imposed if the Service "develops sufficient contrary
evidence to rebut the probative value of the evidence put forth by the parties."

Prop. Reg. section 53.4958-6(c) states that the presumption may be rebutted by additional information as
to the reasonableness of compensation or fair market value of property. Unfortunately, the standard
employed by the proposed regulations sets the bar for rebutting the presumption lower than contemplated
by Congress.

The earlier comments of this Committee recommended that the presumption of reasonableness be
rebutted only by evidence sufficient to establish that one or more of the criteria for the application of the
presumption were not met. Under that approach, if amounts are paid in a good faith belief that the
payments are reasonable and the obligation was incurred consistent with ordinary business care and
prudence, the presumption may not be rebutted by subsequently developed evidence which would also
have constituted appropriate information if available at the time of the approval of the transaction.

We continue to believe that the foregoing is the correct approach and that the evidence to refute should
address the process, not the result. The central issue for refuting the rebuttable presumption should be
whether the information was appropriate and reasonable, and developed with the care an ordinarily
prudent person would exercise under similar circumstances, and not whether the conclusions derived from
the information are the same as subsequent views. In short, we recommend the adoption of an approach
similar to the business judgment rule.

B. Appropriate Data

The proposed regulations under section 53.4958-6(d)(2)(i) would be strengthened by the clarification of
the phrase "similarly situated organizations." We believe that the reference was intended to suggest
comparison to organizations performing similar functions or having assets or revenues similar to the
applicable tax-exempt organization. We believe the regulations would be improved by making this more
specific.

Section 53.4958-6(d)(2)(i) of the proposed regulations correctly considers an independent compensation
survey to be relevant information. However, there is also an example of a transaction that does not satisfy
the rebuttable presumption of reasonableness due to the lack of appropriate data as to comparability; the
survey used in this example is a national survey which is not specifically customized for the organization
and further "does not divide its data by any measure of . . . size or any other criteria." Based on this
language, some may conclude that an independent customized survey is mandatory. In order to clarify
whether there is a need for a customized compensation survey, the regulations should contain a statement
to the effect that customized surveys are not mandatory to satisfy the requirement of comparability of
data.

In addition, a statement in Prop. Reg. section 53.4948-6(d)(2)(i) as to a period of viability for any
comparability data could eliminate unnecessary expense for many organizations. For example, the
regulations could include a statement that comparability data developed by an organization would be
valid for a period of three years.

C. Documentation

The time within which to complete documentation under Prop. Reg. section 53.4958-6(d)(3)(ii) may be
too narrow for many situations. For example, a meeting of a committee or board may take place within
too short a period of time prior to the next meeting of the committee or board to permit adequate
preparation of the written or electronic records of the governing body or committee. In addition, state law
does not generally provide specific requirements for the approval of minutes or records by a governing
body, and the requirements set forth in the proposed regulations may impose additional, unnecessary
burdens on applicable tax-exempt organizations that do not currently follow the practice of reviewing and
approving the records and minutes prepared by responsible corporate officers.
A. In General

The committee report states that an applicable tax-exempt organization’s exemption should not be revoked solely because it has engaged in one or more excess benefit transactions unless the aggregate excess benefit rises to a level that calls into question whether, on the whole, the organization functioned as a tax-exempt organization at the time of such transaction or transactions. We believe that this general principle should be stated in the regulations to provide guidance and increased clarity for the exercise of the Service’s administrative discretion regarding revocation.

We have considered factors that might appropriately be considered in determining whether an applicable tax-exempt organization’s exemption should be revoked on account of excess benefit transactions. We believe that there is no single, all-encompassing formulation of factors or mode of analysis that can be applied to every case. Nevertheless, we suggest that there are several factors that routinely should be considered and weighed before revocation of exemption is asserted. Such factors should take into account that the excess benefit transaction or transactions may be aberrational and unlikely to recur and that fault should be assessed against those responsible for the transaction or transactions and not against innocent beneficiaries of the organization’s charitable, educational, or other tax-exempt activities.

B. Interaction with Church Audit Rules

We believe that, because of the potentially intrusive nature of inquiries to churches involving alleged excess benefit transactions and the First Amendment concerns that such intrusion raises, it is appropriate that the church audit rules of section 7611 be used in initiating and conducting inquiries and examinations of possible excess benefit transactions involving churches.