

IRS GUIDANCE: WHEN INTERMEDIATE SANCTIONS MAY BE COUPLED WITH STATUS REVOCATION

The IRS has always said that revocation of exempt status would be an additional remedy in its arsenal in any case in which it imposes the intermediate sanctions excise taxes on one or more “disqualified persons” as a consequence of an exempt organization’s participation in an “excess benefit transaction.” Formal guidance, however, was not provided to identify the circumstances in which both intermediate sanctions excise taxes and status revocation are likely to be invoked by the IRS.

On September 9 the IRS and Treasury Department issued proposed regulations setting forth guidelines concerning the circumstances in which revocation of the tax-exempt status of an organization that has participated in an “excess benefit transaction” may also be invoked by the IRS because the organization has provided more than incidental private benefit in violation of its obligation to be operated exclusively (primarily) for the benefit of the public. The proposed regulations would amend the current regulations under section 501(c)(3) to identify specific factors that will be considered by the IRS in determining whether a section 501(c)(3) “applicable tax-exempt organization” that engages in one or more excess benefit transactions will continue to qualify as being described in section 501(c)(3). The proposed regulations have no apparent application to section 501(c)(4) “applicable tax-exempt organizations.”

The proposed regulations identify the factors to be considered by the IRS in determining whether an organization might no longer satisfy the requirements for section 501(c)(3) status principally as a consequence of its failure to satisfy the requirement that it be operated “exclusively” (primary) for one or more exempt purposes because more than an insubstantial part of its activities is not in furtherance of an exempt purpose. The factors identified are:

- (1) The size and scope of the organization’s regular and ongoing activities that further exempt purposes before and after the excess benefit transaction(s) occurred;
- (2) The size and scope of the excess benefit transaction(s) (collectively, if more than one) in relation to the size and scope of the organization’s regular and ongoing activities that further exempt purposes;
- (3) Whether the organization has been involved in repeated excess benefit transactions;
- (4) Whether the organization has implemented safeguards that are reasonably calculated to prevent future violations; and
- (5) Whether the excess benefit transaction(s) has been “corrected,” or the organization has made good faith efforts to seek correction from the disqualified person(s) who benefited from the excess benefit transaction(s).

In evaluating these factors (which are said not to be “exclusive” – but no other factors are suggested), no one factor is to be given greater or lesser weight than any others, except that factors (4) and (5) will be weighed more heavily in favor of continuing to recognize exemption in situations in which the organization discovers the excess benefit transaction(s) and takes

prompt corrective action before discovery by the IRS. Correction of the excess benefit transaction(s) after discovery by the IRS will never, standing alone, constitute a sufficient basis for continuing to recognize exemption.

None of the several examples provided to illustrate the application of the principles described above involved a hospital or health care organization. Nevertheless, it is clear that these principles will apply in the same fashion to all categories of “applicable tax-exempt organizations.” The examples provided do clearly demonstrate an intention by the IRS to permit continued qualification for tax-exempt status even in circumstances in which (1) the organization did not engage in substantial or significant ongoing exempt activities before the excess benefit transaction(s) occurred, (2) the excess benefit transaction(s) is substantial in size and scope compared to the organization’s regular ongoing exempt activities, and (3) the organization has been involved in repeated excess benefit transactions, *provided* it can be demonstrated that the organization discovers these facts prior to an IRS examiner discovering them and *both* (4) the organization immediately implements safeguards that are reasonably calculated to prevent future violations of the intermediate sanction rules and (5) the organization takes prompt action to correct the excess benefit transaction(s), including making good faith efforts (including litigation) to seek correction from the “disqualified person(s)” who benefited from the excess benefit transaction(s). It is key both to take remedial action and effect correction of the transaction(s) promptly upon discovery of the occurrence of an excess benefit transaction(s), and it is critical to take those actions prior to IRS discovery of the transaction(s).

The proposed regulations also make it clear that inadvertent and insubstantial excess benefit transactions will not result in revocation of tax-exempt status.

In addition to identifying the factors described above, the proposed regulations also provide guidance concerning the “private benefit” standard in circumstances that do not involve the occurrence of excess benefit transactions. In this regard, the proposed regulations provide examples, based upon case law, illustrating that prohibited private benefits need not involve the provision of economic benefits to private persons (so that non-economic benefits may suffice), and that prohibited private benefit may occur even in circumstances in which payments made to private persons are reasonable and not excessive.

The proposed regulations will not be effective until their publication as “final” regulations in the Federal Register. Written comments and requests for a public hearing concerning the proposed regulations must be received by the IRS by December 8, 2005.