Treasury Issues Final Intermediate Sanctions Regulations

On January 21, the Treasury released its final “Intermediate Sanctions” regulations, replacing temporary regulations issued last year.¹ The final regulations continue to impose hefty excise taxes on individuals who improperly gain financially from their transactions with tax-exempt entities such as hospitals (so-called “excess benefit transactions”). Generally, the final regulations make only minor changes to the temporary regulations. Most notably, and in accord with the temporary regulations, the final regulations refrain from defining “revenue sharing” arrangements, despite authority to do so in the governing statute. The final regulations are effective January 23.

The regulations are issued under Internal Revenue Code Section 4958 (Section 4958), which permits the Internal Revenue Service (IRS) to impose Intermediate Sanctions on tax-exempt entities making excessive payments to certain insiders. Although the taxes may seem severe, in many cases they are an attractive alternative to the IRS’s alternative course of action—revoking an entity’s tax-exempt status.

Next Steps for Health Care Entities
Tax-exempt health care entities that did not review their relationships with disqualified persons last year under the temporary regulations should do so now. Entities that have already acted to comply with the temporary regulations should nonetheless review the discussion below of some of the minor changes detailed in the final regulations in order to take advantage of any applicable clarifications set forth by the IRS in the final regulations. Because of the stiff penalty for failing to timely correct an excess benefit transaction, and the legal and factual analysis required to comply with the regulations, health care entities should act quickly and seek assistance from legal counsel to avoid liability under the Intermediate Sanctions regulations.

Excise Tax on Excise Benefits Transactions
Section 4958 imposes a tax of 25 percent on the recipient of any excess benefit. If the excess benefit transaction is not corrected within the appropriate time period, an additional tax of 200 percent of the excess benefit is imposed. Organization managers also face a tax of 10 percent of the excess benefit (up to a cap of $10,000 per transaction) if they participate knowingly, willfully and without reasonable cause in an excess benefit transaction.
Changes from the Temporary Regulations
A discussion of key provisions of the temporary Intermediate Sanctions regulations may be found in Client Alert 137. As noted above, the final regulations make no significant changes to the temporary regulations. The following summarizes some of the highlights of the final regulations:

- **No Discussion of Revenue Sharing Arrangements:** Provisions in the 1998 proposed regulations that attempted to define types of “revenue sharing” arrangements that would be subject to the Intermediate Sanctions regulations evoked significant criticism from the industry. Accordingly, the temporary regulations merely reserved a separate section for regulations governing revenue sharing transactions (providing that, in the meantime, such transactions would be evaluated under the general regulations defining excess benefit transactions). The final regulations also refrain from describing or specifically regulating revenue sharing arrangements, but reserves the right to further regulate them in the future, noting: “[t]he IRS and the Treasury Department will continue to monitor these types of transactions, and if appropriate, will consider issuing specific rules to regulate them.”

- **Section 115 Exemptions:** IRC Section 115 exempts income received by a governmental entity from taxation, not the entity itself. Consequently, application of provisions in the temporary regulations that excluded from the definition of an “applicable tax-exempt organization” any “governmental entity that is exempt from (or not subject to) taxation without regard to IRC Section 501(a)” were unclear. The final regulations revise this requirement to provide that, under Section 4958, a governmental unit or its affiliate is not an “applicable tax-exempt organization” if it: (i) is exempt from (or not subject to) taxation without regard to section 501(a); or (ii) is relieved from filing an annual return pursuant to the authority of Treasury regulations under section 6033 (which relieves organizations from filing annual returns when not necessary for the efficient administration of the tax law).

- **Disqualified Persons:** The final regulations do not incorporate changes suggested by commentors to the “disqualified person” provisions of the regulations, but did include revised examples (i.e., providing that a management company could be a “disqualified person,” thereby clarifying that entities, not just individuals, could be “persons having substantial influence” under the Intermediate Sanctions regulations).

- **Corrections When an Organization Goes Out of Business:** The temporary regulations applied a vague “related to” test when determining a substitute organization for payment of correction amounts in the event that property must be returned to an organization that no longer exists or is no longer tax-exempt, namely, that the correction amount could not be paid to an organization that was “related to” the disqualified person. The final regulations replace the relatedness test with a requirement that a disqualified person is not also a disqualified person with respect to the organization receiving the correction amount. The final regulations also require that a Section 501(c)(3) organization receiving the correction amount: (i) be a publicly supported charity that (ii) has been in existence for at least 60 calendar months ending on the correction date. The final regulations thereby prevent a disqualified person from creating a new organization to receive the correction amount and also prevents the disqualified person from making or recommending any grants or distributions by an organization receiving the correction amount.
- **Timing of Reasonableness Test Rules with Respect to Forfeiture Risk:** The final regulations clarify that the general timing rules for determining reasonableness apply to property that is subject to a substantial risk of forfeiture. The general timing rules provide that, for fixed payments, reasonableness is determined at the time the parties enter the contract, and for non-fixed payments, reasonableness is determined based on all facts and circumstances up to and including the date of payment.

- **Contemporaneous Evidence:** The final regulations clarify that written evidence of an organization’s reasonable belief that a benefit was non-taxable can also be written contemporaneous evidence that a transfer was approved as compensation (as required by the regulations), even if the belief is later proven erroneous. The written evidence must exist on or before the due date of applicable federal tax returns (defined in the final regulations).

- **Safe Harbors:** The Treasury chose not to change provisions of key safe harbors, despite requests to do so, although it modified certain provisions and examples. For example, although some commentors objected to the safe harbor permitting reliance on appropriate professionals such as appraisers and accountants, the Treasury retained the provision, believing that such reliance indicated that a manager has not “fail[ed] to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction”—part of the “knowing” standard under the law. In contrast, again with respect to the “knowing” standard, the Treasury revised the safe harbor to no longer require that an organization manager rely on the fact that the requirements of the rebuttable presumption of reasonableness be satisfied. Rather, the organization manager’s participation in a transaction will not be considered “knowing” if the appropriate authorized body has met the requirements of the rebuttable presumption for the given transaction.

- **Special Rule on Substantiation:** The final regulations include a new special rule providing that compliance with the specific substantiation requirements of the final regulations does not relieve that organization of compliance with other IRS requirements and guidance (e.g., Section 162 or 274 substantiation rules).

**Conclusion**

As indicated, the final regulations make no significant changes to the temporary Intermediate Sanctions regulations. For healthcare organizations, it is significant that the Treasury chose not to define revenue sharing arrangements, though it reserved its right to do so in the future.

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1 26 CFR 53.4958-0 through 53.4958-8. The temporary regulations did not expire until January 4, 2004, unless final regulations were issued prior to that time. For a discussion of provisions of the temporary regulations, see Client Alert 137.


3 A similar rule applies to Section 501(c)(4) organizations, except for the publicly-supported charity requirement.


5 Importantly, the Treasury noted that the relief offered here is only a safe harbor such that failure to satisfy the requirements does not necessarily mean that an organization manager has acted knowingly. In addition, in response to an informal comment regarding the definition of an “authorized body” with respect to approval by an “authorized body” for purposes of establishing the presumption, the Treasury also indicated that an individual may constitute either a committee of, or a party authorized by, an organization’s governing body to act on its behalf, subject to applicable state law requirements.
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