NOTES AND COMMENTS
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ABSTRACT: In this Article, the author presents and explains two flow charts that facilitate the analysis of the intermediate sanctions provisions. The first chart guides one in determining whether a particular transaction is subject to the sanctions. The second assists in calculating the monetary amount of any applicable sanction.

On the following pages are two flow charts that show the operation of Section 4958 of the Internal Revenue Code,¹ the so-called “intermediate sanctions” legislation. These sanctions can apply to transactions between healthcare providers and certain tax-exempt organizations, including not-for-profit hospitals.²

This Article updates a set of charts that appeared in a 1999 issue of the Journal of Health Law.³ Since that time, the IRS has issued final regulations under Section 4958,⁴ the first Tax Court opinion addressing Section 4958 has been published,⁵ and the IRS has issued several items of guidance in this area.⁶

The first chart shows the analysis to determine whether Section 4958 applies to a given transaction or relationship. Generally, three requirements must be satisfied. First, one party to the transaction must be an “applicable tax-exempt organization.”⁷ Second, the other party to the transaction must be a “disqualified person.”⁸ Third, the transaction or relationship between the two parties must be an “excess benefit transaction.”⁹ An additional step in the analysis is to determine whether the “rebuttable presumption of reasonableness” applies.¹⁰

The second chart shows the steps to determine the amount of the sanction. First, the base on which the sanctions are levied must be

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calculated. Next, the chart considers separately the sanctions on a “manager” of the applicable tax-exempt entity and the sanctions on a “disqualified person.” With respect to managers, the analysis winds through the five major defenses that are available. In the case of a disqualified person, the chart addresses whether abatement is available under Section 4962, and whether the second-tier tax applies. If a person is both a manager and a disqualified person, the total sanction is the sum of the separately computed sanctions.

In order to understand the charts better, several observations are worth keeping in mind. First, the IRS’ final regulations under Section 4958 do not address “revenue sharing” transactions and explicitly reserve the right to issue regulations in this area at some later time. Although the final regulations contain some very general information on revenue sharing transactions, it is likely that more specific rules will be developed in the coming years.

Second, the flow charts analyze a hypothetical transaction between a person or entity and an applicable tax-exempt entity. For these purposes, a “transaction” includes the provision of goods or services. Accordingly, the term covers both property exchanges and compensation arrangements.

Third, analyzing a transaction under Section 4958 could be done in a number of different ways. The approach of the flow charts, however, is to divide the analysis into two steps: (1) whether sanctions apply; and (2) if so, the amount of the sanction.

Finally, the flow charts are intended as a general aid to understand the operation of Section 4958. They should be read in conjunction with Section 4958, the final regulations, and the other guidance that has appeared in recent years. Obviously, the charts do not constitute legal advice. Moreover, the charts were drafted to favor breadth over depth. For example, the charts do not attempt to define “thirty five percent controlled entity” or “manager,” but merely show where in the analysis such concepts belong.

Endnotes


In general.—The term “excess benefit transaction” means any transaction 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 such benefit.

8 Id.

9 Id.

10 Treas. Reg. § 53.4958-6 (2002) (establishing a rebuttable presumption that a transaction is not an excess benefit transaction).

11 Id. § 53.4958-1(d)(4)(i) (the person did not “knowingly” participate in the transaction), (d)(4)(iii) (the person relied on a written, reasoned professional opinion), (d)(4)(iv) (the charity satisfied the rebuttable presumption of reasonableness for the transaction), (d)(5) (the person’s participation was not “willful”), and (d)(6) (the person’s participation was due to “reasonable cause”).
Step One: Whether Sanctions Apply

Is the Charity now (or at any time in the 5-year period ending on the date of the Transaction) an organization described in I.R.C. § 501(c)(3) or (4)?

- NO
- YES

Was the Charity an organization described in section 501(c)(3) or (4) at any time in the past and had its exemption revoked because of inurement or excess benefit transactions?

- NO
- YES

Does the Charity satisfy an exception (e.g., certain private foundations, governmental units and foreign organizations)?

- NO
- YES

Is the person automatically treated as a disqualified person by virtue of holding certain powers within an applicable tax-exempt organization?

- NO
- YES

Is the Person automatically treated as a disqualified person by virtue of his relationship to another disqualified person (e.g., family member, 35% controlled entity, etc.)?

- NO
- YES

Is the Person treated as a disqualified person after the facts-and-circumstances test?

- NO
- YES

Does the Person come within any exceptions to the facts-and-circumstances test?

- YES
- NO

Does the Charity provide an economic benefit to the Person that exceeds the value of the consideration received in exchange?

- NO
- YES

Do the benefits constitute fixed payments made pursuant to an initial contract?

- YES
- NO

Are the benefits disregarded for purposes of I.R.C. § 4958 (e.g., non-taxable fringe benefits, expense reimbursements, etc.)?

- NO
- YES

Does the rebuttable presumption of reasonableness apply?

- NO
- YES

Does contrary evidence exist to rebut the presumption?

- NO
- YES

SANCTIONS APPLY

SANCTIONS DO NOT APPLY

Note:

This chart analyzes whether sanctions apply where one party (the “Person”) has entered into a relationship (the “Transaction”) with another party (the “Charity”).
**Step Two: Amount of Sanctions**

**Determine the base on which sanctions are levied:**
- If the Transaction is a “revenue sharing transaction,” the base is equal to all benefits provided by the Charity pursuant to the Transaction.
- For all other Transactions, the base is equal to the excess of all benefits provided by the Charity over all benefits received by the Charity in exchange.

**Determine the Person’s relationship to the Transaction:**
- If Person is a “manager” of the Charity, the sanction is computed as follows:
- If Person is a “disqualified person” with respect to the Transaction, the sanction is computed as follows:

**Note:**
This chart analyzes the amount of the sanction that could be levied on one party (the “Person”) with respect to an excess benefit transaction (the “Transaction”) entered into with another party (the “Charity”). If the Person is both a “manager” and a “disqualified person,” the total sanction is the sum of the separately computed sanctions.

**Did the Person correct the Transaction within the period specified in I.R.C. § 4963(e)?**
- YES
  - The Transaction was due to “reasonable cause.”
- NO
  - The Transaction was not due to “willful neglect.”

**The Person did not “knowingly” participate in the Transaction.**
- YES
  - The Person’s participation was not “willful.”
- NO
  - The Person’s participation was due to “reasonable cause.”

**The Person relied on a written, reasoned professional opinion.**
- YES
  - The Charity satisfied the rebuttable presumption of reasonableness for the Transaction.
- NO
  - 10% of base ($10,000 cap)

**The Person qualifies for the safe harbor under Treas. Reg. § 301.6724-1(d)(1)(ii)(D).**
- YES
  - The Transaction is corrected within the period specified in I.R.C. § 4958(f)(5).
- NO
  - 225% of base (no cap)

**Did the Person correct the Transaction within the period specified in I.R.C. § 4963(e)?**
- YES
  - The Transaction was due to “reasonable cause.”
- NO
  - The Transaction was not due to “willful neglect.”

**The Person did not “knowingly” participate in the Transaction.**
- YES
  - The Person’s participation was not “willful.”
- NO
  - The Person’s participation was due to “reasonable cause.”

**The Person relied on a written, reasoned professional opinion.**
- YES
  - The Charity satisfied the rebuttable presumption of reasonableness for the Transaction.
- NO
  - 10% of base ($10,000 cap)