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By Joseph C. Mandarino, Esq.*
Troutman Sanders LLP
Atlanta, Georgia

What For-Profit Healthcare Providers Need To Know About The Intermediate Sanction Rules

Most for-profit healthcare organizations are probably vaguely aware that in 1996 Congress enacted legislation to provide for "intermediate sanctions" against tax-exempt organizations.[1]

The development of these rules has been keenly followed by tax-exempts, and most of the commentary and analysis of these rules has been driven by attorneys specializing in tax-exempt organizations. However, as recent events have demonstrated,[2] the main burden of the intermediate sanction rules will fall not on tax-exempt organizations, but on taxable entities and individuals who transact business with tax-exempts. Indeed, in some cases, the rules will even apply to deals between for-profit entities.[3]

Because the intermediate sanction rules effectively use the tax laws as a way to restrict business activities, and because these rules primarily affect for-profits, this article attempts to explain the rules outside of the prism of tax law and to describe only those aspects of the rules that are likely to impact for-profit healthcare providers, such as doctors, hospitals, ancillary service providers, and others. Accordingly, other aspects of the rules are ignored.

Part I provides a short overview of the intermediate sanction rules, the penalties that can be assessed against taxable entities and individuals, and the conditions that must be satisfied before the penalties will apply. Part II addresses each of these conditions and considers the various techniques that taxable entities can use to avoid penalties. Part III provides additional consideration of how, in practice, the rules can be used abusively and suggests ways to avoid this. Finally, Part IV discusses briefly the recent Tax Court opinion in the *Caracci* case, the first intermediate sanctions court opinion, in which $1.3 million in penalties were assessed against the for-profit parties and none against the tax-exempt entity.

I. BACKGROUND

The intermediate sanction rules are in § 4958 of the Internal Revenue Code and in the tax regulations promulgated thereunder.[4] The purpose behind § 4958 is to discourage certain

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* Joseph C. Mandarino is a tax partner in the Atlanta office of Troutman Sanders LLP. His practice is primarily concerned with the taxation of a broad variety of business transactions and taxpayers, including both for-profit and not-for-profit healthcare providers and payors.
[1] The law is found in § 1311(a) of the Tax Payer Bill of Rights, Pub. L. No. 104-168 (1996), codified at 26 U.S.C. § 4958.
[2] *See Caracci v. Commissioner*, 118 T.C. No. 25 (2002), discussed in Part IV, below.
[3] See the discussion in Part II.A of former tax-exempt organizations.
[4] Any § references are to the Internal Revenue Code of 1986, as amended (the Code) and the Treasury Regulations promulgated thereunder. On January 22, 2002, the IRS issued final regulations under § 4958. T.D. 8978, 2002-7 I.R.B. 500.

transactions between tax-exempt entities and for-profit entities under which the consideration does not reflect fair market value (FMV). The rules accomplish this by imposing penalty taxes on the difference between the actual consideration and FMV (the spread). Interestingly, none of the penalties fall on the exempt organization itself.[5]

However, a significant two-tier penalty tax is imposed on the for-profit party. First, an initial 25% tax is imposed on the spread.[6] The for-profit organization then has a specified period in which to remedy the transaction.[7] In general, a transaction can be remedied if the for-profit party transfers enough cash or property to the tax-exempt party to make up for the less-than-FMV consideration it originally paid. In addition, in the case of ongoing payments such as salary or rent, the parties will have to adjust the consideration to reflect FMV or terminate the arrangement. If the transaction is not remedied, then a second tax, equal to 200% is imposed.[8] Because this second tax is double what the for-profit would have to pay if it simply corrected the transaction, the practical result is that a for-profit will be forced to correct the transaction rather than pay the 200% tax.

The application of these rules can be understood with a few simple examples.

Example 1: Provision of Services. Assume a hospital and a doctor agree on a salary of $100,000 for a year's work. If the FMV salary is actually $80,000, and the other requirements of § 4958 are met, then the IRS will able assess a first-tier tax of 25% on the spread of $20,000, for a tax of $5,000. If the doctor does not then remedy the transaction by paying back the hospital $20,000, plus interest, the IRS can assess a tax of $40,000 (200% of the spread). In addition, if the parties wish to continue the contract, the salary must be readjusted to reflect FMV.

Example 2: Sale of Property. Now assume instead that the hospital agreed to sell some land to the doctor for $80,000. If the FMV of the land is actually $100,000, and the other requirements of § 4958 are met, then, as above, the doctor will be assessed a first-tier tax of $5,000 (25% of the $20,000 spread). The doctor could remedy the transaction by paying an additional $20,000 plus interest. If the doctor does not, the IRS can assess a tax of $40,000 (200% of the spread).

Thus, there are three primary consequences of running afoul of § 4958:

- the for-profit will be liable for a 25% tax on the spread between FMV and the actual consideration paid;
- the for-profit will be required to pay the tax-exempt an amount equal to the spread plus interest; and
- the arrangement will have to be re-priced to reflect FMV going forward (or will have to be terminated).

Because these are significant consequences, a for-profit entity should be careful not to enter into a transaction that could be governed by § 4958. There are three primary conditions that must be present for § 4958 to apply: (1) an "applicable tax-exempt organization" and (2) a "disqualified person" must enter into (3) an "excess benefit transaction."

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[5] A tax is imposed on the tax-exempt's management, equal to the lesser of 10% of the spread to a maximum of $10,000. Code § 4958(a)(2).
[6] Code § 4958(a)(1).
[7] Code § 4958(b), (f)(6).
[8] Code§ 4958(b).

Parts II.A, II.B, and II.C of this article address these defined terms. Failing to satisfy any of these conditions means § 4958 will not apply. In addition, even if all three conditions are satisfied, the tax regulations provide for a "rebuttable presumption of reasonableness" that negates the tax. Part II.D discusses how to establish this presumption.

II. MEETING THE REQUIREMENTS

A. Applicable Tax-Exempt Organization

As noted, the intermediate sanction rules only apply if one of the parties is an "applicable tax-exempt organization."[9] Therefore, as a threshold matter, a for-profit firm must determine whether the other party to a transaction fits within this definition, an inquiry that is not always obvious.

Section 4958(e) and the tax regulations set forth a complex definition for "applicable tax-exempt organization." There are three general categories of organizations that satisfy the definition. However, the rules also set forth three exclusions that trump the general categories. The following paragraphs address these categories and the exclusion.

Category 1: Current 501(c)(3) and (c)(4) Organizations

The first category is relatively straightforward: an organization currently exempt under 501(c)(3) or (c)(4).[10]

In most cases, a § 501(c)(3) organization is required to apply for tax-exempt status, and its status can easily be researched.[11] Certain types of § 501(c)(3) organizations, such as religious organizations, do not have to apply, and it may be more difficult to research whether they come within this category.[12] However, the fact would become evident upon a review of the organization's tax returns.

Section 501(c)(4) organizations present more difficulties. Generally such organizations are not required to file a tax exemption application with the IRS. Therefore, the rules provide that this category includes any exempt organization that: (i) has formally applied for recognition under § 501(c)(4), (ii) has filed tax documents as a § 501(c)(4) organization, or (iii) has merely held itself out as a § 501(c)(4) organization.[13]

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[9] Code § 4958(c)(1)(A), (e); Treas. Reg. § 53.4958-2.
[10] Code § 4958(c)(1); Treas. Reg. § 53.4958-2(a)(1). To review for non-tax practitioners, § 501(c)(3) describes a broad group of organizations and includes many religious, charitable, scientific, literary, or educational groups. Section 501(c)(4) includes non-profit civic leagues, social welfare organizations, and local employee associations. From the lay perspective, the main difference between the two is that donations to a (c)(3) organization are treated as charitable contributions, while donations to a (c)(4) organization are not. Code § 170(c)(2). Contributions to a (c)(4) may, however, be deductible under Code § 162 as trade or business expenses.
[11] Code § 508.
[12] Code § 508(c).
[13] Treas. Reg. § 53.4958-2(a)(4).

A further complication is that many organizations that could be exempt under 501(c)(4) may also qualify for exemption under 501(c)(6).[14] Note that while (c)(3) and (c)(4) organizations are subject to the intermediate sanction rules, (c)(6) organizations are not. Therefore, if a for-profit is considering a significant transaction with an organization that could qualify under either (c)(4) or (c)(6), a useful planning tool would be to condition the closing on the organization's filing for and receiving tax exemption under § 501(c)(6). Caveat: if the organization had held itself out as a (c)(4) in the past, it is not clear that this strategy would work.

Category 2: Organizations that Were Exempt in the Last Five Years

The second category is also somewhat straightforward: any organization that would have been within Category 1 at any time during the five-year period ending on the date of the transaction.[15] Thus, if a § 501(c)(3) organization lost its tax-exempt status three years ago, then it would still be treated as an applicable tax-exempt organization.

Note that an excess benefit transaction "occurs" on the date on which the excess economic benefit is received by the for-profit party.[16] This may occur sometime after the execution of a contract. To be cautious, the for-profit should treat the five-year look back period as beginning at least five years before the date of contract formation.

Unfortunately, it is difficult to research whether a currently taxable company was previously a tax-exempt entity. Again, the fact should be evident upon a review of the company's tax returns.

Category 3: Organizations that Lost Their Exemption Because of Inurement or Excess Benefit Transactions

The third category is a trap for the unwary. The rules provide that an organization that would be described in Category 1 but for the fact that its exempt status was revoked due to participation in inurement or an excess benefit transaction is *always* treated as an applicable tax-exempt organization.[17] Accordingly, doing business with a corporation that now appears to be a regular for-profit entity, but which was in fact exempt several decades ago, could trigger the application of § 4958.

For example, if a § 501(c)(3) hospital lost its tax-exempt status forty years ago because of political activities, then it would not be treated as an applicable tax-exempt organization and no transactions with such a hospital could be subject to penalty taxes. However, if the hospital lost its tax-exempt status because of inurement or an excess benefit transaction, then, under a literal reading of the tax regulations, the hospital will always be treated as an applicable tax-exempt organization.

Again, it may be difficult to research whether a currently taxable company was previously tax-exempt, and it is even more difficult to determine how such a company lost its exempt status.

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[14] Section 501(c)(6) includes non-profit business leagues, chambers of commerce, real-estate boards, and boards of trade.
[15] Code § 4958(e)(2); Treas. Reg. § 53.4958-2(a)(1).
[16] Treas. Reg. § 53.4958-1(e)(1).
[17] Treas. Reg. §53.4958-2(a)(5).

Reviewing old tax returns may be reasonable for the five-year look back period of Category 2, but may be more difficult in this situation.

It has been suggested that this risk could be mitigated by a representation in the transaction documents to the effect that the counter party is not currently, never has been, and has never held itself out as, exempt under §§ 501(c)(3) or (c)(4). While such a representation would be helpful in flushing out this datum, a breach of such a representation may not yield a remedy. Recall that the purpose of § 4958 is to penalize--and cause the correction of--certain types of transactions. Yet if a former exempt organization breached this representation, and if as a result the other party incurred tax liability under § 4958, it would follow that it would be liable for any taxes imposed on the other party and for any amounts paid to "correct" the transaction. Query whether a court would consider enforcing such a remedy as against public policy.[18] Ideally, the IRS will clarify that a reasonable effort to ascertain whether a counter party is an "applicable tax-exempt organization" is sufficient to defeat liability under § 4958 if the counter party breaches a representation such as the one set forth above.

4. Exclusions: Private Foundations, Governmental Entities and Certain Foreign Organizations

The rules set out three types of organizations that are excluded from the operation of § 4958, even if they are otherwise described in the foregoing three categories. Thus, transactions with such organizations are not subject to § 4958. The three types of organizations are as follows:

- a private foundation,
- a governmental entity that is exempt from tax under a provision other than § 501(a), and
- a foreign organization, recognized by the IRS or by treaty, that receives substantially all of its support from non-U.S. sources

The second exclusion is likely to be most commonly used. It would include any governmental entity that voluntarily applied for a determination of its § 501(c)(3) status. Because many municipal and county hospitals that were already exempt under § 115 have also received recognition under § 501(c)(3), this provision effectively excludes them from § 4958.

B. Disqualified Person

A for-profit company will only be subject to the penalty taxes of § 4958 if it is a "disqualified person."[19] Generally, a disqualified person is any person who was in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization at any time during the five-year period ending on the date of the transaction.[20]

The rules on whether an individual or entity is a disqualified person set forth two "per se" tests and one "facts-and-circumstances" test. In addition, there are three exceptions to the factual test (which, confusingly, do not apply to the per se tests). Because of the complexity of this definition, the following flow-chart may prove helpful:

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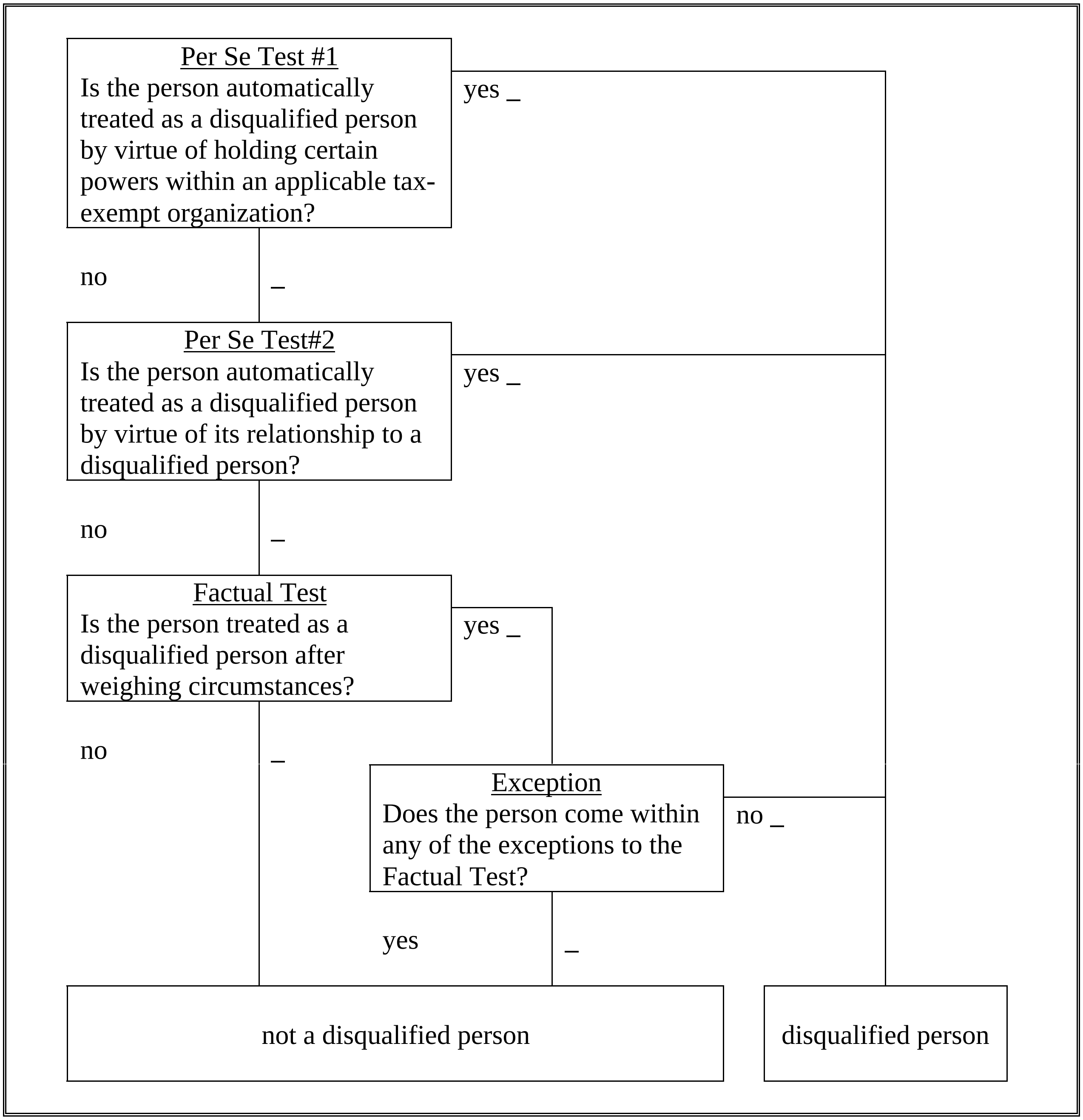
[18] See generally the discussion in this regard in Part III, below.
[19] Code § 4958(a)(1), (b); Treas. Reg. § 53.4958-1(c).
[20] Code § 4958(f); Treas. Reg. § 53.4958-3(a)(1).



The following paragraphs trace the steps outlined above.

1. Per Se Test #1: Persons Deemed to Have Substantial Influence Because of Powers

The regulations provide that persons who hold certain powers or positions within an organization are deemed to have substantial influence over that organization.[21] These positions and powers are as follows:

- Any individual serving on the governing body of the organization who is entitled to vote on any matter over which the governing body has authority.
- Presidents, chief executive officers, or chief operating officers (and any person who, regardless of title, has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization).
- Treasurers and chief financial officers (and any person who, regardless of title, has ultimate responsibility for managing the finances of the organization).
- Persons with a material financial interest in a "provider-sponsored organization" (as defined in § 1855(e) of the Social Security Act, 42 U.S.C. § 1395w-25).

2. Per Se Test #2: Persons Related to Disqualified Persons

The regulations provide that persons in certain relationships to disqualified persons are themselves deemed to be disqualified persons.[22] These relationships are as follows:

- The following family members of disqualified persons:[23] spouse; brothers or sisters (by whole or half blood); spouses of brothers or sisters (by whole or half blood); ancestors; children; grandchildren; great grandchildren; and spouses of children, grandchildren, and great grandchildren.
- The following entities owned by disqualified persons: [24] a corporation in which disqualified persons own more than 35% of the combined voting power; a partnership in which disqualified persons own more than 35% of the profits interest; or a trust or estate in which disqualified persons own more than 35% of the beneficial interest.

Note that for purposes of the 35% controlled entity rule, special constructive ownership rules apply. [25]

3. Factual Test

As noted, if a person is not automatically treated as a disqualified person under the foregoing two "per se" tests, then a facts-and-circumstances test applies.[26] The following circumstances tend to indicate that a person has substantial influence over the affairs of an organization: [27]

- The person founded the organization.
- The person is a substantial contributor to the organization.
- The person's compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the person controls.

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[21] Treas. Reg. § 53.4958-3(c).
[22] Treas. Reg. §53.4958-3(b).
[23] Code § 4958(f)(1)(B), (f)(4); Treas. Reg. §53.4958-3(b)(1).
[24] Code § 4958(f)(1)(C), (f)(3); Treas. Reg. §53.4958-3(b)(2).
[25] Code § 4958(f)(3)(B); Treas. Reg. §53.4958-3(b)(2)(iii).
[26] Treas. Reg. §53.4958-3(e).
[27] Treas. Reg. §53.4958-3(e)(2).

- The person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees.
- The person manages a discrete segment or activity of the organization that represents a substantial portion of the organization.
- The person owns a controlling interest in a corporation, partnership, or trust that is a disqualified person.
- The person is a non-stock organization controlled by one or more disqualified persons.

In contrast, the following circumstances tend to indicate that a person does not have substantial influence over the affairs of an organization: [28]

- The person has taken a bona fide vow of poverty as an employee, agent, or on behalf of a religious organization.
- The person is an attorney, accountant, investment manager or like advisor whose sole relationship to the organization is providing professional advice (without having decision-making authority) with respect to transactions from which the person will not economically benefit (aside from customary fees received for the professional advice rendered).
- The direct supervisor of the individual is not a disqualified person.
- The person does not participate in any management decisions affecting the organization as a whole or a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole.
- Any preferential treatment a person receives based on the size of that person's contribution is also offered to all other donors making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions.

4. Exceptions to the Factual Test

Finally, the regulations provide that certain types of persons are deemed not to have substantial influence over an organization, even if they otherwise satisfy the factual test.[29] These exceptions do not apply to the per se tests outlined above.

Note that two of these exceptions apply to tax-exempt organizations and are not therefore likely to be useful to a for-profit entity.[30] However, if a for-profit entity did substantial business with applicable tax-exempt organizations, it may want to consider converting to a § 501(c)(3) or (c)(4) status. For example, a professional medical corporation could conceivably convert to charitable status and thereby avoid penalty taxes on its dealing with, for instance, a tax-exempt hospital. However, any salaries or other business arrangements between the former owners of the corporation and the newly-exempt organization could now become subject to scrutiny under § 4958.

[28] Treas. Reg. § 53.4958-3(e)(3).
[29] Treas. Reg. § 53.4958-3(d).
[30] Treas. Reg. § 53.4958-3(d)(1), (d)(2).

The third exception applies to certain employees of the applicable tax-exempt organization.[31] Specifically, any full- or part-time employee is deemed not to be a disqualified person if he or she meets the following three conditions:

- the person receives economic benefits, directly or indirectly from the organization, of less than a defined annual amount ($90,000 as of 2002);
- the person is not automatically deemed a disqualified person by virtue of either of the per se tests (see above); and
- the person is not a substantial contributor to the organization.

Note that while the income ceiling would appear to exclude most full-time physicians, it is not pro-rated and therefore could cover part-time physicians, as well as many types of ancillary service providers. Because this exception only applies to employees, a healthcare provider who otherwise comes within the exception but is classified as an independent contractor may want to revise his or her arrangements to be treated as an employee.

5. Other Issues

The rules provide that, in cases of multiple organizations affiliated by common control or governing documents, the determination of whether a person has substantial influence is made separately for each applicable tax-exempt organization.[32] This rule will tend to increase the chances that a given person will be treated as a disqualified person.

For example, assume a hospital system has several affiliated tax-exempt entities, all under common control. Assume also that a physician has substantial influence over one of these entities, but has no influence over any of the others. If the test applied in the aggregate, then the physician might not be a disqualified person because he or she did not have substantial influence over the system as a whole. By applying the test to each entity, however, the physician will be treated as a disqualified person with respect to the one entity noted.

If a for-profit entity has sufficient contacts with one member of a group of affiliated tax-exempt organizations such that it might be treated as a disqualified person with respect to that member, it may make sense to structure any business transactions with other members. However, there are special rules that would ignore this arrangement if the nominal contracting party were merely an agent for another member.[33]

Finally, note that the disqualified person test has a five-year look back period. Therefore, it is not enough to establish that at the time the transaction was entered into the for-profit entity had no influence over the counter party.

C. Excess Benefit Transaction

1. General

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[31] Treas. Reg. § 53.4958-3(d)(3).
[32] Treas. Reg. § 53.4958-3(f).
[33] Treas. Reg. § 53.4958-4(a)(2).

The third requirement before the penalty taxes of § 4958 can apply is that the parties enter into an "excess benefit transaction."[34] In general, this is defined as "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, and the value of the economic benefit provided exceeds the value of the consideration received for providing the benefit."[35] In practice, this comes up in four different ways: (1) an exempt organization pays more than fair market value (FMV) to buy or rent property from a for-profit; (2) a for-profit pays less than FMV to buy or rent property from an exempt organization; (3) an exempt organization pays more than FMV for services provided by a for-profit; and (4) a for-profit pays less than FMV for services provided by an exempt organization.

2. Definition of FMV

Thus, the key inquiry is whether the consideration for the transaction is at FMV. The regulations provide that, in the case of property, FMV is the price at which property or the right to use property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell or transfer property or the right to use property, and both having reasonable knowledge of relevant facts.[36] In the case of services, FMV is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation).[37] This is not particularly trenchant guidance and, as anyone who has endured a tax audit can attest, it would be unusual for the IRS and a taxpayer to readily agree on the FMV of goods or services. Accordingly, it may be advisable to obtain an appraisal or valuation to determine whether the consideration in the transaction reflects FMV.

Several items covered by the regulations are worth considering. First, special rules apply to defeat attempts to funnel consideration through taxable subsidiaries, or to otherwise avoid penalty taxes by the use of intermediaries and agents.[38] Second, a significant exception applies to "initial contracts" between an exempt organization and a for-profit entity, as discussed below.[39]

3. Initial Contract Exception

In order to fit within the exception, several conditions must be satisfied. First, an "initial contract" means a binding written contract between an applicable tax-exempt organization and a person who was not a disqualified person immediately prior to entering into the contract.[40]

Second, the contract must provide for fixed payments.[41] For these purposes, "fixed payment" means an amount set forth in the contract or determined by a fixed formula, which is to be paid

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[34] Code § 4958(a)(1), (b); Treas. Reg. § 53.4958-1(a).
[35] Code § 4958(c)(1)(A); Treas. Reg. § 53.4958-1(b), -4(a)(1).
[36] Treas. Reg. § 53.4958-4(b)(1)(i).
[37] Treas. Reg. § 53.4958-4(b)(1)(ii).
[38] Treas. Reg. § 53.4958-4(a)(2).
[39] Treas. Reg. § 53.4958-4(a)(3).
[40] Treas. Reg. § 53.4958-4(b)(3)(iii).
[41] Treas. Reg. § 53.4958-4(b)(3)(ii).

in exchange for specified services or property. If a formula is used, it can incorporate future events or contingencies so long as no person exercises discretion when calculating the amount of a payment or deciding whether to make a payment. A specified event or contingency can include revenues (or other measure) of one or more activities of the tax-exempt organization. However, "fixed payment" does not include any amount paid under a reimbursement (or similar) arrangement where discretion is exercised by any person with respect to the amount of expenses reimbursed.

Third, substantial performance is required. That is, the exception does not apply during any year in which the person fails to substantially perform its obligations under the contract.[42]

Finally, certain actions will cause an initial contract to be treated as a new contract.[43] If a contract that provides that it is terminable or subject to cancellation by the applicable tax-exempt organization (other than as a result of a lack of substantial performance) without the other party's consent and without substantial penalty to the organization, then the contract is treated as a new contract as of the first date on which such termination or cancellation, if made, would be effective. In addition, if the parties agree to a material change to a contract, it is treated as a new contract as of the date the change is effective. For these purposes, a material change includes an extension or renewal of the contract (other than one that results from a person unilaterally exercising an option expressly granted by the contract), or a more than incidental change to any amount payable under the contract.

Accordingly, if a for-profit is about to enter into a significant contract with a tax-exempt and as a result will likely be treated as a disqualified person (for instance, a hospital management contract), the parties should seek to come within the initial contract exception. In addition, the parties should consider avoiding terms that would tend to shorten the protection afforded by this exception. Thus, providing the hospital with early termination rights will tend to diminish the effect of this exception. In contrast, incorporating extension and renewal rights in the contract (rather than leaving it to the parties to negotiate in the future) will extend the application of the exception. Finally, pay-or-play type payments will not be sheltered. Thus, golden parachute payments will not be within the exception. Coupling such payments with reasonable future consulting obligations, or the like, may be sufficient to come within the exception.

4. Netting

Note that certain types of non-FMV transactions do not give rise to penalties. Thus, to reverse the list set out above, no taxes are implicated if (1) an exempt organization pays *less* than FMV to buy or rent property from a for-profit entity, (2) a for-profit entity pays *more* than FMV to buy or rent property from an exempt organization, (3) an exempt organization pays *less* than FMV for services provided by a for-profit entity, or (4) a for-profit entity pays *more* than FMV for services provided by an exempt organization. Unfortunately, there is no guidance permitting netting of different transactions so that any penalties would be assessed only on an aggregate basis. However, a for-profit entity involved in many transactions with the same tax-exempt organization may wish to embody these transactions in one contract or under a master agreement.

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[42] Treas. Reg. § 53.4958-4(b)(3)(iv).
[43] Treas. Reg. § 53.4958-4(b)(3)(v).

D. Rebuttable Presumption Of Reasonableness

The regulations provide a special presumption that may be of help in avoiding the penalty taxes of § 4958. If the conditions discussed below are satisfied, then the transaction is presumed to be at fair market value.[44] The IRS can still rebut this presumption, but only if it develops "sufficient contrary evidence to rebut the probative value of the comparability data" relied upon by the tax-exempt organization."[45]

This means that successfully raising the presumption will shift the balance of proof from the taxpayer to the IRS. While § 7491 statutorily shifts the burden of proof from the taxpayer to IRS in all courts, this shift does not apply if, in the case of a for-profit party, the organization has a net worth in excess of $7 million ($2 million in the case of an individual) or has more than 500 employees, and does not apply at the IRS audit or appeals levels.[46] Therefore, it will still generally be desirable for for-profit parties to satisfy the presumption.

In order to raise the presumption, the following conditions must be satisfied:[47] (1) the transaction must be approved by an authorized body (the board of directors or an appropriate committee) composed entirely of individuals who did not have a conflict of interest with respect to the transaction; (2) the authorized body must obtain and rely upon appropriate data as to comparability prior to approving the transaction; and (3) the authorized body must contemporaneously document the basis for its approval.

Satisfying the first and third conditions should be relatively straightforward. However the second condition is less clear. The regulations provide that an authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether the arrangement in its entirety is reasonable and at FMV.[48]

In the case of compensation, appropriate data as to comparability includes: compensation levels paid by similarly situated organizations (taxable and tax-exempt) for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person.[49] In the case of property, appropriate data as to comparability includes current independent appraisals of the value of all property to be transferred and offers received as part of an open and competitive bidding process.[50]

Note that the steps necessary to raise this presumption are within the control of the tax-exempt entity, not the for-profit entity. However, the chief beneficiary of the presumption is the for-profit entity. Accordingly, the for-profit should insist that all three requirements be satisfied as a

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[44] Treas. Reg. § 53.4958-6(a).
[45] Treas. Reg. § 53.4958-6(b).
[46] Code §§ 7491(a)(2)(C) and 7430(c)(4)(A)(ii) (incorporating by reference 28 U.S.C. § 2412(d)(1)(B)).
[47] Treas. Reg. § 53.4958-6(a).
[48] Treas. Reg. § 53.4958-6(c)(2).
[49] Treas. Reg. § 53.4958-6(c)(2)(i).
[50] *Id.*

condition of closing, and should retain documentation to establish this (copies of minutes, etc.). Splitting the cost of an appraisal or valuation report, if that is necessary, may be reasonable in this situation.

III. ABUSIVE USE OF SECTION 4958

An additional risk posed by the intermediate sanction rules is that an unhappy exempt organization could use them as leverage to renegotiate a contract. For example, assume that an exempt hospital enters into a long-term arrangement with a for-profit management company to operate the hospital. Several years into the relationship, a competing management company offers the hospital better terms. The hospital cannot terminate the contract without significant penalties, so it tries to renegotiate some of the terms. The management company asserts that it has a valid and enforceable contract and will not bend. The hospital then whispers into the ear of the management company that it is now of the view that the consideration does not reflect FMV and, accordingly, it may be bound to notify the IRS. In essence, the hospital can use § 4958 as a tool to try to void contracts that it is unhappy with.

It is not clear how the management company could protect itself in this hypothetical. As noted, it could obtain a valuation of the consideration at the time the contract is entered into, and could also require the hospital to take the steps necessary to establish the presumption of reasonableness. In addition, it could incorporate in the contract a recital that the parties agree that the consideration reflects FMV, was negotiated at arm's length, and is supported by a third-party appraisal. The contract could also contain a covenant that the parties will not take any positions inconsistent with the appraisal as to each other or third parties. Finally, the contract could provide for actual or liquidated damages in the event of a breach of this covenant.

However, courts generally do not enforce contract provisions that are contrary to public policy.[51] Therefore, it is not clear whether such a covenant could be enforced. For example, assume that the hospital violates the covenant and brings in the IRS. Assume also that the IRS prevails and assesses penalty taxes under § 4958. If the management company then sued the hospital for damages arising from the breach of the covenant, it seems unlikely it would prevail.

The hospital would probably argue that the facts established that the original contract violated the law (specifically § 4958), and that under general principles of contract law, the covenant is not enforceable on the grounds of public policy. In substance, if the covenant were enforceable in this instance, the management company would be able to shift the penalty taxes onto the hospital, a result that contradicts the policy behind § 4958 of imposing penalties on the disqualified person, not the tax-exempt organization.[52]

Assume, however, that the IRS did not prevail and the management company then sued for damages under the covenant. The result is far from clear, but the hospital could argue that, as long as it acted in good faith, awarding damages against the hospital would frustrate the public policy behind § 4958 and would permit the management company, in essence, to contractually

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[51] *See, e.g.,* Restatement (Second) of Contracts § 174 (1981).
[52] *See, e.g.,* Restatement (Second) of Contracts § 174(3)(a) ("In weighing a public policy against enforcement of a term, account is taken of . . . the likelihood that a refusal to enforce the term will further the policy.")

silence the hospital. Of course, threatening to bring in the IRS in order to get changes to an otherwise valid and fair contract would seem to be an excellent example of bad faith. But if the management company could not show bad faith, it is not clear that a court would permit damages in such a situation.

IV. LESSONS FROM THE CARACCI CASE

Recently, the United States Tax Court issued its decision in a case involving the conversion of several tax-exempt home health agencies to for-profit status.[53] The case has been eagerly awaited by observers because it is the first decision involving the intermediate sanction rules.

In the case, the Caracci family formed three tax-exempt home healthcare companies under the "Sta-Home Health Agency" name in the mid-1970s in Mississippi. Family members served as the principal officers of these organizations. By the 1990s, the agencies employed over 1,000 people and had a strong reputation in the community. Virtually all the patients were covered by Medicare, and under the reimbursement rules then in effect, the agencies generally ran losses. In 1995, the Caracci family established three for-profit corporations. An appraisal was obtained and the tax-exempt agencies were determined to have a negative fair market value. The exempt organizations then transferred all their assets to the new corporations in exchange solely for the assumption of their liabilities.

The crux of the Tax Court's opinion was the valuation question and it considered testimony from experts on both sides. Ultimately, the Tax Court found that the assets had a net worth of approximately $5.2 million and imposed a penalty tax equal to 25% of that amount (approximately $1.3 million) on the Caraccis.

Interestingly, the Caraccis obtained an appraisal and relied on the advice of attorneys and accountants in structuring the transaction. Although the government originally asserted penalties against the Caraccis in their capacity as officers of the tax-exempt organizations, they dropped that claim and proceeded against the Caraccis solely as the purchasers of the assets; i.e., in their capacity as "disqualified persons." Presumably, this was because the appraisals and reliance on professional advice served to insulate the Caraccis from the "manager" penalties.[54]

The government also sought a 200% "second tier" penalty against the Caraccis, but the Tax Court found that assertion unripe and essentially invited the Caraccis to avoid the potential $10.4 million penalty by transferring the assets back to the original tax-exempt entities.

Finally, the government sought to revoke the tax-exempt status of the agencies that had transferred their assets. The Tax Court refused, noting that one of the policy rationales for intermediate sanctions was precisely to impose a penalty on certain transactions rather than the more draconian remedy of total revocation.

The case demonstrates that:

- Managers of tax-exempt healthcare organizations can successfully avoid penalties by using appraisals and relying on professional advice.

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[53] *Caracci v. Commissioner*, 118 T.C. No. 25 (2002), *see* **HLD**, v. 30, n. 7, at p. 89.
[54] *See, e.g.,* Treas. Reg. § 53.4958-1(d).

- Tax-exempt organizations are likely to retain their exempt status in an intermediate sanction case.
- For-profit entities involved in business transactions with not-for-profit organizations can suffer significant tax penalties if the IRS determines the transactions did not reflect FMV.
- The Tax Court will scrutinize appraisals thoroughly and disregard conclusions that it feels are defective.
- Although an exempt organization can shield itself from penalties with an appraisal that the court ultimately determines is defective, a for-profit purchaser cannot.

Thus, the entire penalty fell on the for-profit parties, and not on the tax-exempt organizations.

V. Conclusion

Given the foregoing, individuals and for-profit entities must be aware that transactions with parties that are currently, or were formerly, tax-exempt could trigger significant penalties. The checklist that follows summarizes some practical suggestions, but as noted, it may be impossible to completely eliminate this risk.

CHECK LIST FOR FOR-PROFIT ENTITIES

1. Applicable Tax-Exempt Organization

- representation in the contract (sample: "X corporation is not currently and has never been an organization exempt from tax under § 501(c)(3) or (c)(4) of the Code, has never held itself out as such an organization, has never filed tax returns or information statements relating to such an organization, and will not qualify as such an organization, hold itself out as such an organization, or file tax returns or information statements relating to such an organization for any periods during which this agreement is in force and effect")
  - this is primarily intended to elicit discussion of the issue
  - enforcement of a remedy for breach of this representation may be contrary to public policy
- research
  - review organization's current and past tax returns (5 years minimum)
  - review IRS Publication 78, Cumulative List of Organizations (covers only some § 501(c)(3) organizations) (online search can be found at http://www.irs.gov/exempt/display/0,,i1%3D3%26genericId%3D6873,00.htm)
- determine if counter party fits one of the exclusions:
  - private foundation
  - governmental entity
  - foreign organization
- mitigation:

- if a for-profit is considering a significant transaction with an organization that could qualify under either 501(c)(4) or (c)(6), condition the closing on the organization's filing for and receiving tax exemption under § 501(c)(6)
- caveat: if the organization had held itself out as a (c)(4) in the past, it is not clear that this strategy would work.

2. Disqualified Person

- per se test #1
  - directors, presidents, CEOs, COOs, CFO, treasurers, and the like
  - persons with a material financial interest in a provider-sponsored organization
- per se test #2
  - certain family members of disqualified persons
  - corporations, partnerships, trusts, and estates in which a disqualified person has a 35% interest
- factual test
  - weigh pro and con factors
  - consider whether exceptions apply
- other issues
  - affiliated entities -- selection of counter party
  - five-year look back period

3. Excess Benefit Transaction

- obtain appraisal/valuation to substantiate FMV of consideration
- initial contract exception
  - verify lack of disqualified person status currently and for last five years
  - do payments meet "fixed payment" test
  - substantial performance requirement
  - treatment as new contract upon certain events
  - consider:
    - eliminating or moving back unilateral cancellation right
    - incorporating extension and renewal provisions from the outset

- netting -- consider making multiple arrangements subject to same contract or master agreement

4. Rebuttable Presumption of Reasonableness

- make satisfying the presumption a conditions of closing
- consider sharing the cost of appraisal or valuation

5. Other

- incorporate recital that the consideration reflects FMV, was negotiated at arm's length, and is supported by a third-party appraisal the presumption a conditions of closing
- covenant that neither party will take any position inconsistent with the appraisal as to each other or third parties
- provide for actual or liquidated damages for breach of the covenant

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Notes

* Joseph C. Mandarino is a tax partner in the Atlanta office of Troutman Sanders LLP. His practice is primarily concerned with the taxation of a broad variety of business transactions and taxpayers, including both for-profit and not-for-profit healthcare providers and payors.

[1] The law is found in § 1311(a) of the Tax Payer Bill of Rights, Pub. L. No. 104-168 (1996), codified at 26 U.S.C. § 4958.

[2] *See Caracci v. Commissioner*, 118 T.C. No. 25 (2002), discussed in Part IV, below.

[3] See the discussion in Part II.A of former tax-exempt organizations.

[4] Any § references are to the Internal Revenue Code of 1986, as amended (the Code) and the Treasury Regulations promulgated thereunder. On January 22, 2002, the IRS issued final regulations under § 4958. T.D. 8978, 2002-7 I.R.B. 500.

[5] A tax is imposed on the tax-exempt's management, equal to the lesser of 10% of the spread to a maximum of $10,000. Code § 4958(a)(2).

[6] Code § 4958(a)(1).

[7] Code § 4958(b), (f)(6).

[8] Code§ 4958(b).

[9] Code § 4958(c)(1)(A), (e); Treas. Reg. § 53.4958-2.

[10] Code § 4958(c)(1); Treas. Reg. § 53.4958-2(a)(1). To review for non-tax practitioners, § 501(c)(3) describes a broad group of organizations and includes many religious, charitable, scientific, literary, or educational groups. Section 501(c)(4) includes non-profit civic leagues, social welfare organizations, and local employee associations. From the lay perspective, the main difference between the two is that donations to a (c)(3) organization are treated as charitable contributions, while donations to a (c)(4) organization are not. Code § 170(c)(2). Contributions to a (c)(4) may, however, be deductible under Code § 162 as trade or business expenses.

[11] Code § 508.

[12] Code § 508(c).

[13] Treas. Reg. § 53.4958-2(a)(4).

[14] Section 501(c)(6) includes non-profit business leagues, chambers of commerce, real-estate boards, and boards of trade.

[15] Code § 4958(e)(2); Treas. Reg. § 53.4958-2(a)(1).

[16] Treas. Reg. § 53.4958-1(e)(1).

[17] Treas. Reg. §53.4958-2(a)(5).

[18] See generally the discussion in this regard in Part III, below.

[19] Code § 4958(a)(1), (b); Treas. Reg. § 53.4958-1(c).

[20] Code § 4958(f); Treas. Reg. § 53.4958-3(a)(1).

[21] Treas. Reg. § 53.4958-3(c).

[22] Treas. Reg. §53.4958-3(b).

[23] Code § 4958(f)(1)(B), (f)(4); Treas. Reg. §53.4958-3(b)(1).

[24] Code § 4958(f)(1)(C), (f)(3); Treas. Reg. §53.4958-3(b)(2).

[25] Code § 4958(f)(3)(B); Treas. Reg. §53.4958-3(b)(2)(iii).

[26] Treas. Reg. §53.4958-3(e).

[27] Treas. Reg. §53.4958-3(e)(2).

[28] Treas. Reg. § 53.4958-3(e)(3).

[29] Treas. Reg. § 53.4958-3(d).

[30] Treas. Reg. § 53.4958-3(d)(1), (d)(2).

[31] Treas. Reg. § 53.4958-3(d)(3).

[32] Treas. Reg. § 53.4958-3(f).

[33] Treas. Reg. § 53.4958-4(a)(2).

[34] Code § 4958(a)(1), (b); Treas. Reg. § 53.4958-1(a).

[35] Code § 4958(c)(1)(A); Treas. Reg. § 53.4958-1(b), -4(a)(1).

[36] Treas. Reg. § 53.4958-4(b)(1)(i).

[37] Treas. Reg. § 53.4958-4(b)(1)(ii).

[38] Treas. Reg. § 53.4958-4(a)(2).

[39] Treas. Reg. § 53.4958-4(a)(3).

[40] Treas. Reg. § 53.4958-4(b)(3)(iii).

[41] Treas. Reg. § 53.4958-4(b)(3)(ii).

[42] Treas. Reg. § 53.4958-4(b)(3)(iv).

[43] Treas. Reg. § 53.4958-4(b)(3)(v).

[44] Treas. Reg. § 53.4958-6(a).

[45] Treas. Reg. § 53.4958-6(b).

[46] Code §§ 7491(a)(2)(C) and 7430(c)(4)(A)(ii) (incorporating by reference 28 U.S.C. § 2412(d)(1)(B)).

[47] Treas. Reg. § 53.4958-6(a).

[48] Treas. Reg. § 53.4958-6(c)(2).

[49] Treas. Reg. § 53.4958-6(c)(2)(i).

[50] *Id.*

[51] *See, e.g.*, Restatement (Second) of Contracts § 174 (1981).

[52] *See*, *e.g.*, Restatement (Second) of Contracts § 174(3)(a) ("In weighing a public policy against enforcement of a term, account is taken of . . . the likelihood that a refusal to enforce the term will further the policy.")

[53] *Caracci v. Commissioner*, 118 T.C. No. 25 (2002), *see* **HLD**, v. 30, n. 7, at p. 89.

[54] *See*, *e.g.*, Treas. Reg. § 53.4958-1(d).