CURRENT PROPOSALS FOR PUBLIC CHARITY

INTERMEDIATE SANCTIONS

by Marion Fremont-Smith

If all goes as members of the Ways and Means Committee staff anticipate, either this year or next it is likely that Congress will enact legislation containing a series of penalty taxes on "public charities" similar to those contained in Chapter 42 that have applied since 1969 to private foundations. We commonly describe these taxes as the private foundation excise taxes. Now we have a new nomenclature. They are referred to as Intermediate Sanctions -- which is what they are, in fact, and will be in the form of excise taxes that will apply in just the way the private foundation ones operate -- that is, a first level tax in a somewhat nominal amount for a violation and a second level tax equal to the amount involved in the violation if it is not corrected within a set period after notice from the Service.

The recent impetus for this legislation has come from Treasury and Service officials who came to realize in the late 1980's that revocation of exemption is an inappropriate sanction to control the behavior of exempt organizations. The first official call for public charity sanctions was voiced in 1992 in a report issued by the IRS Penalty Task Force. They were included as a formal request to Congress during testimony presented to the Oversight Subcommittee of the House Ways and Means Committee by Commissioner Margaret Milner Richardson on
June 15, 1993. Actually, this request had been preceded by the introduction of a bill by Congressmen Stark in 1991 that would have imposed an excise tax on self-dealing transactions involving medical service organizations. However, it was not given serious attention at the time and although there were a few commentators before that who had pointed to the need for a better way to deal with transgressions that did not penalize the beneficiaries of these organizations, the issue had not been given much attention by members of the voluntary sector.

The first response to the Commissioner's testimony from the exempt organization community came from Independent Sector whose Board of Directors approved draft legislation imposing what it described as Public Charity Intermediate Sanctions in October of 1993. The Independent Sector proposal would apply to payments of unreasonable compensation and transactions between public charities and insiders in which the charity paid more or received less than fair market value. On November 22, 1993, Congressman Stark introduced a revised version of his earlier bill, entitled this time "The Exempt Organization Reform Act of 1993". It would impose excise taxes in cases of private inurement and self-dealing involving organizations exempt under Sections 501(c)(3) and (4) other than private foundations.

Most recently, on March 16, 1994, an Administration representative, testifying before the Oversight Subcommittee, called for legislation to meet what it described as the need for carefully-targeted reform measures that would improve compliance
with the tax laws by public charities. The administration's proposal was targeted at transactions involving "excess benefits" provided by organizations exempt under Sections 501(c)(3) or (4) to an insider in cases involving the payment of unreasonable compensation or a non-fair market value transfer of the organizations assets or income.

Assuming, as I believe we should, that some form of intermediate sanctions will be enacted in the foreseeable future, I would like to consider whether these proposals will serve to compel compliance with rules governing the fiduciary duty of officers and trustees by looking at the nature of the transactions that are proposed as the subject of tax penalties; who is to be punished for violations; the degree of involvement considered necessary to cause the sanctions to be applied; and whether there are any transactions that should be exempted because of the amount involved or the nature of the transgression.

DESCRIPTIONS OF CURRENTLY PROPOSED INTERMEDIATE SANCTIONS

The proposals now before Congress are alike in calling for a two-tier set of excise taxes that follow the pattern of the private foundation provisions as well as the limits on lobbying codified in 1976 and the prohibitions against intervention in political campaigns adopted in 1987. Where they differ is in their response to the other questions I have posed. I will attempt to describe these differences and then address some of the problems raised by them. I hope that I can provide enough
background to permit us in our discussion to reach some
conclusions as to the form of legislation we believe should be
enacted.

Before I turn to the descriptions, I do want to note
that there are segments of the bar and the independent sector
that oppose any form of intermediate sanctions. The objections
come on the one side from those who do not believe that the
situation is sufficiently grave and the extent of misdeeds
sufficiently widespread to warrant the degree of federal
intrusion contemplated in the proposed legislation and on the
other from those who fear any government interference in the day
to day operations of public charities. This latter group divides
into two sub-sets -- one which opposes any government
interference and the other which is fearful that intrusion of the
type proposed will inhibit the best individuals from serving as
directors and trustees of public charities and will prevent
public charities from entering into transactions that are
beneficial to them even if self-dealing is involved.
I. Descriptions of Prohibited Behavior

The first question -- what will we limit -- has the widest
range of answers, although even in 1969 there was general
agreement that a total prohibition on self dealing by private
foundations would be impossible to police, as well as
disadvantageous to the general public. The proposals now being
considered would prohibit, inter alia, non-fair market value
transactions, excessive compensation, private inurement/private
benefit, political activities and excessive lobbying. The last three are already subject to the sanction of revocation, so that an intermediate sanction for acts of this nature would perpetuate existing substantive standards that are conceded by all to be too vague to be effectively enforced. They do not form part of the proposals being considered by the Oversight Subcommittee, and I will not describe them further, as it is evident that the Service believes they would be unenforceable as part of a system involving excise tax penalties.

The three proposals I will describe in detail each attempt to be more specific. The Stark bill does this by adopting a definition of "self-dealing" that mirrors Section 4941, although it then tacks on a prohibition against private inurement that is not defined in any meaningful way. Thus, self-dealing is defined as any direct or indirect transfer, lease, or license of property between the organization and disqualified persons unless it would occur as part of the course of ordinary activities or business of the organization on a basis comparable to similar transactions with non-insiders. As noted, this rule is similar to that in Section 4941 and contains its exceptions for loans without interest to the charity and the furnishing of goods and services without charge. The separate prohibition against inurement would apply to any "direct or indirect inurement of any part of the net earnings" of the organization to the benefit of any disqualified person, thereby incorporating the vague standard now in the Code and there is no de minimis rule.
The Independent Sector bill would prohibit the non-charitable use of the income or assets of the organization, further defined as either payment of unreasonable compensation or any purchases, sales, leases or exchanges in which the value paid by the charity exceeds the amount it receives from the self-dealer, with an exception for services provided by the charity in furtherance of its charitable purposes. The proposal does include a de minimis rule whereby any transaction in which the prohibitions would apply only when the value of the consideration given by the charity is greater than $5,000 and exceeds by more than 15 percent the value of the consideration received by the charity. In addition, if the transaction was a result of arm's length negotiation, the burden of proof would be on the Secretary to establish, "by clear and convincing evidence," that the transaction was a non-fair market value one.

The Treasury proposal would prohibit transactions by Section 501(c)(3) and (4) organizations in which an individual receives "excess benefit" by virtue of participating in a non-fair market value transfer in which inadequate consideration is paid to the charity by an insider for property or income. It thereby incorporate a prohibition against payment of unreasonable compensation. (It should be noted that the Administration has not as yet proposed specific legislation, rather, it urged adoption of the concept and offered to provide the text of a bill within two weeks.) A facts and circumstances test would be used to determine reasonableness of compensation or inadequacy of
consideration, and determinations in regard to compensation would be made on the basis of the standards found in Section 162. Approval of the compensation or transfer of assets by an independent governing body would weigh in favor of a finding of reasonableness or adequate consideration. Further, if a non-fair market value transfer was not made as compensation and reported as such, it would be subject to tax even if the insider's compensation would have been reasonable had the transfer been compensatory.

II. Application of the excise taxes

The second question relates to who is to be punished. Here the proposals also differ among themselves as well as from the private foundation provisions where the self-dealing provisions apply only to disqualified persons and foundation managers. Thus, the Stark bill imposes the penalty taxes for self-dealing on "disqualified persons" and "organization managers" and the tax on inurement to the organization, the management and the beneficiary. Disqualified persons are defined to include any person who was an organization manager at any time during the 5 years preceding the date of the prohibited transaction, members of his family and their 35% controlled entities. The definition of organization follows the private foundation formulation but adds any person performing substantial medical services as a physician for the organization under contract. The term "beneficiary" is not defined. To be subject to the tax, the manager must have acted knowing that the act was
prohibited and his participation must have been willful and not
due to reasonable cause (hereinafter the "knowing-not willful
standard"). As with the private foundation provisions, the second
level taxes would apply to the self-dealer if he failed to
correct the transaction and, in the case of a manager, if he
refused to approve of correction.

Independent Sector proposes that the taxes apply
to the beneficiary of a non-fair market value use if the
beneficiary is a disqualified person or a non-disqualified person
who participated in the use knowing it to be prohibited, and if
his action was willful and without reasonable cause. Otherwise
it is to be imposed on the charity. It would also be imposed on
any organization manager who could meet the "knowing-not willful
standard".

The Treasury proposal applies to "insiders" who are
defined as (i) the organizations officers, directors and
trustees, persons otherwise in a position to exercise substantial
influence over the organization's affairs, the family members and
entities controlled by any of these individuals or in which they
have significant beneficial interests. It would also apply to a
former insider if the transaction was approved, formally or
informally, when the recipient was an insider.

III. Amount of the Taxes

As noted, each of the proposals would apply two-levels
of tax and, in two instances, opportunity for abatement. The
details are as follows:
Stark bill:

Initial tax for self-dealing:

on self-dealer 5%
on manager 2.5%

for inurement:

on organization 10%
on manager 2.5%
on beneficiary 5%

Additional tax for self-dealing:

on self-dealer 200%
on manager 50%

for inurement:

on organization 100%
on manager 50%
on beneficiary 200%

limit on manager at both levels $10,000

Amount involved = greater of money and fair market
value of property involved and that received

Independent Sector Bill

Initial tax:

on organization 10%
on beneficiary 10%
on manager 5%

Additional tax

on organization 100%
on beneficiary 100%
Limit on manager at both levels $10,000

Amount involved = amount of the excess compensation or amount by which value of consideration given exceeds amount received

Abatement of Initial tax: if violation was due to reasonable cause and not to willful neglect and act corrected within the correction period

Treasury proposal:

Initial tax:

on insider 25%
on manager 10%

Additional tax:

on insider 200%
on manager none

Amount involved = amount of excess benefit

Abatement of initial tax on insider if there was reasonable cause for payment of the benefit

The Treasury proposal also contains a discussion of the relationship of the excise taxes and revocation of exemption, in which it recommends that if the excess benefit is so egregious that the organization can no longer be considered charitable, both revocation and imposition of the excise tax should occur.
In addition, the excise tax would apply to benefits provided by the organization after it lost its exemption and there would be an "exit" tax similar to that in Section 507.

REFLECTIONS ON THE PROPOSED STANDARDS AND REMEDIES

I suggest that we should evaluate these proposals -- and any variants that have been or will be suggested -- in terms of the appropriateness of the remedies proposed, their likely success in preventing the abuses at which they are directed and the extent of the burden they will place on the organizations to which they are to be applied and the general public which is the beneficiary of these organizations. As to the first consideration, I admit to a strong bias against imposing any taxes on the organization -- under any circumstances. It would serve only to punish the beneficiaries and in most cases would permit the wrong-doers to remain in control of the organization. Thus, an excise tax on charitable assets should be avoided under all circumstances. The Treasury proposal follows this concept; the Stark bill does in the case of self-dealing but not in its proscription against private inurement. The Independent Sector bill attempts to mitigate the adverse effect of a tax on charities by providing that it is to be imposed only if it cannot be imposed on the "beneficiary". However, a non-disqualified beneficiary will not be subject to tax unless it can be shown that he participated in the transaction knowingly and his participation was not willful and

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was due to reasonable cause -- a standard that the Service will find so difficult to overcome that it will be rare for it to attempt to go after the individual and will rather seek the tax from the public charity. The provision shifting the burden of proof to the Service in the case of arm's length negotiations, while offering important protection to managers and disqualified persons, will only increase the interest of Service personnel in looking to the organization for its tax. A possible compromise provision would be to permit abatement of any first level tax on an organization if it went through an institutional correction process in which the managers adopted procedures designed to avoid similar occurrences in the future and, depending on the circumstances, took specific action, including termination, with respect to the individuals involved.

If it were determined that a tax should be imposed on the charity whenever it cannot be applied to a self-dealer or a beneficiary, it might be advisable to consider modifying the "knowing and not willful" exception to cover participation when the manager or self-dealer should have known his participation was in violation of the Code.

The question of whether the proposed remedies will suffice to deter the unwanted behavior is closely tied to the first for in cases it will depend on who is to be subject to the penalty. If it is only the charity, or if the managers are easily exempted, it will not be a sufficient deterrent. On the other hand, and of more wide spread concern is the obverse of
this objection, i.e., is the remedy so severe that it will paralyzed ordinary activity and prevent charities from attracting as their managers the very persons they most want and need. At its extreme, the argument is made that in small communities, ordinary transactions necessary to the charity will be discouraged, (the best person to serve on the board is the only oil dealer in town). The knowing and not willful standard is designed to address this problem. Even more effective is a de minimis proposal such as that in the IS bill. However, both pragmatic and philosophical objections can be made to that proposal. On the practical side, there is the view that the 15% limit is far too lenient; its adherents point out that an excess payment of $150,000 (15% of a transaction involving $1,000,000) should under no circumstances be exempted). On the theoretical side, critics of any de minimis exception argue that it is inconsistent to require revocation of exemption for payment of a benefit of $300 or even $4500, whereas provision of a benefit of $5050 can be penalized without invoking the most extreme penalty. I believe the practicalities warrant foregoing a stand on pure theory and can tolerate the inconsistency in view of the distinct advantages of having a limit on the number of transactions that would need to be reviewed by a responsible board as well as by an agent in the course of an audit.

By far the most troublesome aspects of all of the proposals is the fact that they are attempting to deal with behavior that is not easily subject to precise definition or
measurement. It is simple to say "no self-dealing transactions" and even to add that, nonetheless, it is proper for a manager to provide goods to a charity free of charge or to loan money without interest. It is even easy to permit bargain purchases by the charity for items for which there is a readily available market price. Once one moves beyond that, and particularly whenever one must determine what compensation is "reasonable", one finds oneself in a potential morass where there are no guidelines, let alone a set of commonly agreed upon principles. Thus, at a philosophical level, we can properly object to including a prohibition against payments of unreasonable or excessive compensation. However, almost every case of "wrong-doing" by charities that has been brought to the attention of Congress or been the subject of nation-wide publicity has involved the issue of compensation, so that Congress cannot and, it appears, will not now avoid the issue. Thus, we need to consider how best to set some parameters -- should comparisons be made only among salaries paid by exempt organizations or can and should they be made to for-profit entities and, if so, how do we determine which organizations are sufficiently alike to be compared. You are well aware of the difficulties involved in making these determinations, in great part as a result of the papers presented by Peter and Beverly at previous meetings of our Forum and I find that they have made me more cautious than ever, but also without definite suggestions for dealing with the problem. Perhaps we can take consolation in the fact that we had

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similar concerns after the Section 4944 limitations on jeopardy investments and the catch-all prohibition against non-exempt expenditures in Section 4945 were enacted, yet they have not placed an unreasonable burden on foundation managers, rather, they have undoubtedly improved the administration of foundations, which is what we want to see happen with public charities.

It will be noted that the question of "excessive fund-raising costs", which has been the subject of some limited Congressional inquiry and a greater degree of public attention, is not directly addressed in the substantive portion of any of the proposals that have been described. Neither the Treasury proposal nor the Stark Bill and its explanation deal with alleged fund-raising abuses. In Independent Sector’s explanation of its proposal, it states that cases involving allegedly unreasonable fund-raising costs would be subject to the proposed taxes if the Service could establish that the charity’s staff, outside fund-raising "counsel" or other parties received more than reasonable compensation, but it acknowledges that the provisions would not reach situations in which the compensation was reasonable but the costs equaled or exceeded the value of the contributions received. The authors recognized that there may be abuses involved when a fund-raising effort is carried on solely for the benefit of the individuals involved, but admitted that "it is extremely difficult to frame an intermediate sanctions rule that can differentiate these abuse cases from the far more common situation in which a fund-raising effort simply fails to live up
to the charity's expectations." I would add that it is equally
difficult to frame a sanction that would take into account the
difference between a new or unpopular charitable cause and one
that is well-known or has a particular appeal of the moment.
Presumably, the Treasury and Stark proposals would reach the same
fund-raising contracts that would be subject to tax under the IS
proposal, although they are not mentioned. My preference would
be for Congress to refrain from attempting to correct abuses of
this nature, which are being looked at by the states and can be
dealt with more appropriately in those forums.

As a final word, opponents of intermediate
sanctions are wont to say that the abuses at which they are
directed are far better dealt with by the states and that there
is no need to involve the federal government in matters well
within the province of the state attorneys general. This is
tantamount to saying that no regulation is either needed or
wanted for it is a fact that only ten or so states have
regulatory programs in place that are designed to deal with, let
alone look at the fiduciary behavior of managers of public
charities. Where they are comparatively well-funded and where
there is interest on the part of the attorney general in active
enforcement, they may well be a better situs for regulation than
the IRS. However, in all the other states, including those which
do have an active program to regulate solicitation of charitable
funds, there will be no enforcement. Thus, it is all the more
important that we do our best to assure that the provisions

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incorporated in the Code are the best we can persuade Congress to adopt.

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I have appended to this paper copies of the Stark bill and its explanation, the text of the Independent Sector proposal and the prepared Statement submitted by Assistant Treasury Secretary for Tax Policy, Leslie B. Samuels, to the Ways and Means Oversight Subcommittee on March 16, 1994. I have also added an excellent Annotated Bibliography of Materials on Intermediate Sanctions prepared by a subcommittee of ABA Section on Real Property, Probate and Trusts prepared by a group headed by Victoria B. Bjorklund, Chair of the Subcommittee. The Tax Section's Exempt Organizations Committee has released among its members a first draft of a White Paper in which it would support intermediate sanctions applicable only to the prohibitions against private inurement, more than insubstantial private benefit, electioneering and more than substantial lobbying activities by organizations that have not made the election under Section 501(h). I have not included it here, but believe that copies may be available through the committee. I have also addressed the matter in more general terms in a paper prepared for an Independent Sector Research Seminar in Honor of Brian O'Connell that was held on March 17 and 18. Laura Chisolm presented an excellent Commentary on this paper. We can provide drafts to those interested, but only with the understanding that they are not final and will be revised before publication.
EXEMPT ORGANIZATION REFORM ACT OF 1993

HON. FORTNEY PETE STARK
OF CALIFORNIA
IN THE HOUSE OF REPRESENTATIVES
Monday, November 22, 1993

Mr. STARK. Mr. Speaker, following is the full text of a bill I introduced today, entitled "The Exempt Organization Reform Act of 1993":

H.R.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. EXCLUDE TAXES ON ACTS OF SELF-DEALING AND PRIVATE INCREMENT BY CERTAIN TAX-EXEMPT ORGANIZATIONS.

(a) In general.—Chapter D of the Internal Revenue Code of 1986 (relating to private foundations and certain other tax-exempt organizations) is amended by redesignating subsection D as subsection E and by inserting after subsection C the following new subsection:

"SUBCHAPTER D—ACTS OF SELF-DEALING AND PRIVATE INCREMENT BY CERTAIN EXEMPT ORGANIZATIONS"

Sec. 5558. Taxes on certain acts of self-dealing.

Sec. 5559. Taxes on private increment.

Sec. 5560. Other provisions.

Sec. 5561. Taxes on certain acts of self-dealing.

(a) Initial taxes.—

(1) On self-dealer.—There is hereby imposed a tax on each act of self-dealing between a disqualified person and an applicable tax-exempt organization. The amount of such tax shall be 5 percent of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period. The tax imposed by this paragraph shall be paid by any disqualified person (other than an organization manager acting only as such) who participates in the act of self-dealing.

(2) On organization manager.—In any case in which a tax is imposed by paragraph (1), there is hereby imposed on the participation of any organization manager in any act of self-dealing between a disqualified person and an applicable tax-exempt organization, knowing that it is such an act, a tax equal to 2.5 percent of the amount involved with respect to such act of self-dealing for each year (or part thereof) in the taxable period, unless such participation is not willful and is due to reasonable cause. The tax imposed by this paragraph shall be paid by any organization manager who participated in the act of self-dealing.

(b) Additional taxes.—

(1) On self-dealer.—In any case in which an initial tax is imposed by subsection (a)(1) on any act of self-dealing between a disqualified person and an applicable tax-exempt organization and such tax is not paid within the taxable period, there is hereby imposed a tax equal to 200 percent of the amount involved. The tax imposed by this paragraph shall be paid by any disqualified person (other than an organization manager acting only as such) who participated in the act of self-dealing.

(2) On organization manager.—In any case in which an additional tax is imposed by paragraph (1), if an organization manager refused to agree to part or all of the correction, there is hereby imposed a tax equal to 10 percent of the amount involved. The tax imposed by this paragraph shall be paid by any organization manager who refused to agree to part of all of the correction.

(c) Special rules.—

(1) Joint and several liability.—If more than one person is liable under any paragraph of subsection (a) or (b) with respect to any act of self-dealing, all such persons shall be jointly and severally liable under such paragraph with respect to such act.

(2) Base for management.—With respect to any act of self-dealing, the maximum amount of the tax imposed by subsection (a)(2) shall not exceed $10,000, and the maximum amount of the tax imposed by subsection (b)(2) shall not exceed $10,000.

(d) Self-dealing.—For purposes of this section—

(1) In general.—Except as provided by paragraph (2), the term 'self-dealing' means any direct or indirect transfer, lease, or license of property between an applicable tax-exempt organization and a disqualified person, and otherwise extend the credit to an applicable tax-exempt organization and a disqualified person.

(2) Exceptions.—The term 'self-dealing' shall not include:

(A) the lending of money of a disqualified person to an applicable tax-exempt organization if the loan is without interest or other charge (determined without regard to section 7702) and if the proceeds of the loan are used exclusively for exempt purposes;

(B) the furnishing of goods or facilities by a disqualified person to an applicable tax-exempt organization if the furnishing is without charge and if the goods or facilities so furnished are used exclusively for exempt purposes, and any transfer, lease, or license of property if—

(i) such transfer, lease, or license (as the case may be) of a disqualified person to an applicable tax-exempt organization or such trade or business is on a basis comparable to the basis on which similar transactions are made in the ordinary course of such trade or business with other parties, or

(ii) such transfer, lease, or license (as the case may be) of an applicable tax-exempt organization in the ordinary course of its activities and such transaction is made on a basis comparable to the basis on which similar transactions are made in the ordinary course of such activities with other parties.

(3) Exempt purpose.—For purposes of paragraph (2), the term 'exempt purpose' means—

(A) in the case of an organization described in section 501(c)(3), any purpose specified in section 501(c)(3); and

(B) in the case of an organization described in section 501(c)(4), any purposes specified in section 501(c)(4).

(d) Other definitions.—For purposes of this section—

(1) Taxable period.—The term 'taxable period' means, with respect to any act of self-dealing, the period beginning with the date on which the act of self-dealing occurs and ending on the earliest of—

(A) the date on which notice of deficiency is mailed with respect to the tax imposed by subsection (a)(1); or

(B) the date on which the tax imposed by subsection (a)(1) is assessed, or

(C) the date on which correction of the act of self-dealing is completed.

(2) Amount involved.—The term 'amount involved' means, with respect to any act of self-dealing, the greater of the amount of
money and fair market value of other property given, or the amount of money and fair market value of other property received, in the case of a lease or license, the amount involved is the fair market value of the leased or licensed property. For purposes of this paragraph—

"(A) In the case of the taxes imposed by subsection (a), fair market value shall be determined as of the date on which the act of self-dealing occurs, and

"(B) In the case of the taxes imposed by subsection (b), fair market value shall be the highest fair market value during the taxable period.

SECT. 6212. TAXES ON PRIVATE INUREMENT.

"(a) INITIAL TAXES.

"(1) ON THE ORGANIZATION.—There is hereby imposed an excise tax equal to 10 percent of the amount thereof. The tax imposed by this paragraph shall be paid by the organization with respect to which such inurement occurred.

"(2) ON THE MANAGEMENT.—There is hereby imposed an excise tax equal to 5 percent of the amount thereof. The tax imposed by this paragraph shall be paid by the management with respect to which such inurement occurred.

"(3) ON THE BENEFICIARY.—There is hereby imposed an excise tax equal to 5 percent of the amount thereof. The tax imposed by this paragraph shall be paid by the beneficiary of such inurement.

"(b) ADDITIONAL TAXES.

"(1) ON THE ORGANIZATION.—In any case in which an initial tax is imposed by subsection (a)(1) on any taxable inurement and such inurement is not corrected within the taxable period, there is hereby imposed a tax equal to the amount of such taxable inurement. The tax imposed by this paragraph shall be paid by the organization with respect to which such inurement occurred.

"(2) ON THE MANAGEMENT.—In any case in which an additional tax is imposed by paragraph (1), if an organization manager refused to agree to part of the correction, there is hereby imposed a tax equal to 5 percent of the amount of the taxable inurement. The tax imposed by this paragraph shall be paid by any organization manager who refused to agree to part of the correction.

"(3) ON THE BENEFICIARY.—In any case in which an additional tax is imposed by paragraph (1), there is hereby imposed a tax equal to the amount of such taxable inurement. The tax imposed by this paragraph shall be paid by the beneficiary of such inurement.

"(c) TAXABLE INUREMENT.—For purposes of this section, the term 'taxable inurement' means any direct or indirect inurement of any part of the property of any person described in paragraph (1) or (2) of subsection (a) or (b) of subsection (b) own more than 50 percent of the combined voting power.

"(d) SPECIAL RULES.—For purposes of this section—

"(1) 35-PERCENT CONTROLLED ENTITY.—The term '35-percent controlled entity' means—

"(A) a corporation in which 35 percent or more of its outstanding voting stock is owned by an organization described in section 501(c)(4), 501(c)(5), or 501(c)(6); and

"(B) an organization described in section 501(c)(4), 501(c)(5), or 501(c)(6) that is controlled by an organization described in paragraph (A) and any organization that is 35 percent or more of its outstanding voting stock is owned by an organization described in paragraph (A).

"(2) CONSTRUCTIVE OWNERSHIP RULES.—Rules similar to the rules of paragraphs (3) and (4) of section 4946(a) shall apply for purposes of this subsection.

"(d) APPLICATION OF PRIVATE INUREMENT RULE TO TAX-EXEMPT CIVIC LEAGUES.—For purposes of

SECT. 6213. TECHNICAL AND CONFORMING AMENDMENTS.

"(1) Subsection (a) of section 4965 of such Code is amended—

"(A) by striking 'section 6945' in the heading and inserting 'sections 6945 and 6959'; and

"(B) by inserting before the period 'or a taxable inurement for purposes of section 6945';

"(2) Subsections (a), (b), and (c) of section 6953 of such Code are each amended by inserting 'and 6959' after '6955';

"(3) Subsection (a) of section 4968 of such Code is amended by inserting 'relating to acts of self-dealing, 6959 relating to private inurement' before '6971'; and

"(4) the table of subchapters for chapter 42 of such Code is amended by striking the last entry and inserting the following:


"Subchapter B. Abatement of first and second year interest and tier taxes in certain cases.

"Subchapter C. Effective date.

The amendments made by this section shall apply to transactions occurring on or after January 1, 1994.
It is important to have this process for the incorporation of any U.S. territory to become law if a genuine effort is to be made to bring about decolonization before the end of this century. It remains up to the people of the territories to determine if they want to seek a closer relationship with the United States. This will provide a path to explore arrangements unique to the needs of a territory, while achieving self-government and equality of rights.

The following is the text of the bill to provide for the determination of articles of incorporation for territories of the United States.

**EXEMPT ORGANIZATION REFORM ACT OF 1993**

**IN THE HOUSE OF REPRESENTATIVES**

**HON. FORTNEY PETE STARK**

**OF CALIFORNIA**

**CONGRESSIONAL RECORD—Extensions of Remarks**

**E 3057**

Mr. STARK. Mr. Speaker, today I rise to introduce a bill that would create a category of transactions that would be considered self-dealing because of insiders involved in a transfer of 501(c)(3) and 501(c)(4) organizations, second, clarify that private inurement provisions apply to 501(c)(4) organizations; and third, impose intermediate sanctions on both private inurement and self-dealing transactions.

It is necessary because assets accumulated by nonprofit organizations through tax-exempt status are being raided through certain business transactions and the IRS does not have appropriate sanctions to address the problem.

Problems of insiders inappropriately benefitting from a tax-exempt status are all too common among nonprofit healthcare providers. For this reason, I have introduced this bill now, with the hope that it will be incorporated into any health reform proposal enacted. However, the problem is broader than what is evident in the health care sector. The following examples illustrate transactions in which individuals have enriched themselves at the public’s expense while nonprofit organizations have become more lax.

The Cystic Fibrosis Foundation, one of the country’s largest and best known charities, recently announced a plan to transfer the use of its most valuable assets to the foundation’s current president, Robert K. Dresser. Mr. Dresser reportedly was interested in leaving the nonprofit sector and starting up his own business. To assist Mr. Dresser in his new venture, the board of trustees is considering the transfer of half of the work force of the nonprofit, the direct mail list that raised $13.8 million in contributions last year, the mail order pharmaceutical operation that reported sales of $10 million last year, and its home health service that generated $3.4 million in revenues last year.

In considering the transfer of assets to the current president, the foundation’s board rejected the idea of requiring Mr. Dresser to bid or compete with other companies for the work he now performs. This was not the case when Pat Robertson, chairman of Christian Broadcasting Network (CBN), and his son, Timothy, turned a $150,000 investment into stock worth $90 million by the 1992 sale to the public of cable TV stock they had originally sold to CBN.

The problem is complicated, with twists and turns that often exist in self-dealing and private inurement cases. A cable TV programming company, the Family Channel, was started in 1977 as a division of the nonprofit CBN and financed with charitable donations of $50 million. CBN wanted to sell the Family Channel in 1989, but because the Family Channel was so lucrative that it jeopardized the tax exempt status of the CBN IRS rules require charities to get their revenues from charitable activities rather than from business activities. The family channel subsequently generated $14.5 million in just 9 months of 1989.

For the purchase in 1990, Pat and Tim Robertson formed a for profit company, the International Family Entertainment, Inc., with a minority shareholder and bought the Family Channel. The Robertsons put up $140,000, 2.22 cents a share and the minority shareholder put up $2 billion. IFES Family Channel went public at $15 a share in 1995, and the Robertsons’ $140,000 investment became worth $2 billion. They retain 50 percent control of IFES/Family Channel. The Family Channel continues to be a cash cow. Robertson’s 1992 salary and benefits from IFES/Family Channel amounted to $390,611. His son, Tim, received $465,721 in 1992.

All the while, Robertson remains chairman of the nonprofit CBN that created the lucrative Family Channel.

Health Net in California is a third example of what should not happen. Health Net, not for profit health plan with 94,000 members, proposed a conversion to profit status. Health Net’s board of directors approved an offer by a group of insiders—many of the board members and key management personnel—for significantly less than what other bidders offered. The self-dealing by the organization involved the loss of $47 million dollars.

Health Net insiders led by Health Net chairman Roger Graves initially bid $103 million for Health Net. The bid was later increased to $127. The profit that insiders’ deal would have required them to pay or $1.5 million in cash and a note for the balance owed to be paid out of the profits of the new entity. Tax law requires that the value of the assets at the time of conversion must go to a charitable organization.

When outsiders bid on Health Net, offers ranged from $130 million to $300 million. Salomon Bros. appraised Health Net for one of the bidders and came up with an estimated value of between $350 million and $420 million—more than twice the amount that the board agreed to accept from the Graves group of insiders.

Health Net’s stated reason for the conversion was to gain access to capital and yet they summarily rejected the offer by Blue Cross of California which would have provided a substantial source of debt-free capital, significantly reduced administrative costs and maintained the not-for-profit status. Health Net board members have not been asked to go public by any other group. The indicted insiders have not been asked to go public by any other group. The indicted insiders have been asked to go public by any other group.

Another example of abuse by insiders involved directors of a nonprofit psychiatric hospital purchasing the hospital’s assets for $6.3 million and selling them 2 years later for $28.6 million. In this case, although the IRS retroactively revoked the hospital’s exempt status, no tax penalties exist to levy against the directors who pocketed $23 million on the deal.

In the medical area, there are, and will continue to be, growing number of transactions involving the purchase or sale of exempt properties. Sale of physician practices often involves physicians with a substantial interest in the sale, and the IRS rulings illustrate the amounts and issues at stake.

Under the first ruling, the exempt organization paid $110 million for private medical practices and assets, including intangible assets such as covenants not to compete, HMO contracts, an assembled work force, warranty rights, trademarks and trade names. In the second ruling, the facts involved an $8 million purchase of stock of a private medical corporation whose assets consisted largely of intangible assets such as its trade name, patient files and records, software, a work force in place, contracts to provide medical services, noncompetition agreements, and goodwill.

In both cases, the IRS approval was conditioned on no more than fair market value being paid to the physicians in the practice. However, the IRS cannot rule on valuation in advance; it can only determine whether fair market value was paid when it subsequently reviews the exempt organization. Thus, it could be years before we find out if exempt organizations paid the appropriate amount for these mostly intangible assets which are so hard to value.

Another way insiders profit from their association with a tax exempt organization is through the receipt of no-interest or low-interest loans. According to an April 22, 1993, article in the Philadelphia Inquirer, Children’s Hospital of Philadelphia loaned its president $650,000 to purchase a $550,000 house in Chester County. The loan was for a term of 10 years with no interest. Georgetown University loaned a senior officer of the Medical Center $107,700 at 5 percent interest and $644,380 with no interest charge. A perfect example of charitable contributions being diverted from the charitable purpose.

Under current law, the only sanction available to the IRS to combat private inurement is revocation of the organization’s exempt status. Unfortunately, the IRS rarely imposes this sanction. In addition, even where it is imposed, it may not be effective because there are no penalties imposed directly on the persons responsible for the organization’s loss of exemption.

At a July 10, 1991, hearing before the Ways and Means Committee, the IRS testified that although its agents find questionable transactions involving private benefit and private inurement, they revoking tax exempt status infrequently. According to John E. Parke, Assistant Commissioner of the IRS Exempt Organizations Division, “agents are reluctant to propose revocation of exemption because of the fear of disruption of a hospital’s exempt status greatly outweighs the private profit of a few individuals.”

Current IRS Commissioner Margaret M. Miller testified this year that the lack of immediate sanctions cause “significant enforcement difficulties.”

At the July 10, 1991, hearing, the Treasury Department also testified that the sole sanction for noncompliance under current law---loss of tax exempt status—may mean reexamining the organization’s exemption every year.”
tion. Treasury suggested that immediate sanctions for tax exempt organizations may be needed. In the Treasury's view, such sanctions should be modeled on the private foundation excise tax that imposes penalties on responsible persons. My legislation takes this approach. It is based on the private foundation rules applicable to self-dealing transactions.

A summary prepared by the Joint Committee on Taxation follows:

**EXPLANATION OF BILL**

**PRESENT LAW**

Under the Internal Revenue Code (the "Code"), a tax-exempt charitable organization described in section 501(c)(3) must be organized and operated exclusively for a charitable, religious, educational, scientific, or other exempt purpose, as specified in that section, and no part of the organization's net earnings may inure to the benefit of any private individual or any private foundation. Organizations described in section 501(c)(3) are exempt from the income tax. Section 4944 of the Code provides that a charity must be organized and operated exclusively for charitable, religious, educational, scientific, or other exempt purposes, as specified in that section, and no part of the organization's net earnings may inure to the benefit of any private individual or any private foundation. Organizations described in section 501(c)(3) are exempt from the income tax.

Under the Code, penalty excise taxes may be imposed on private foundations, their managers, and certain disqualified persons for engaging in certain prohibited transactions (such as so-called "self-dealing" and "taxable expenditures") transactions. Under the Code, an initial penalty equal to 25 percent of the amount involved would be imposed on a disqualified person who participates in a disqualified transaction. In general, the "amount involved" refers to the value of any money or other property given, or the fair market value of any money or other property received. The organization or any related disqualified person who participates in a disqualified transaction would be subject to a tax equal to 25 percent of the amount involved (subject to a maximum of $10,000), unless such participation was not willful and was due to reasonable cause.

Additional, second-tier taxes would apply under the Code if the self-dealing transaction is "not correct," meaning undoing the transaction to the extent possible, but at least ensuring that the organization is in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards. If a self-dealing transaction is not corrected within a specified time period (generally ending 90 days after the IRS mails the required notice), then the disqualified person would be subject to a tax equal to 20 percent of the amount involved. Any organization manager refusing to agree to correction would be subject to tax equal to 20 percent of the amount involved (subject to a maximum amount of $10,000). Under the bill, if more than one person is liable for a first-tier or second-tier tax, one person may be held liable for tax imposed on the transaction with respect to any one self-dealing transaction (or instance of taxable inurement, discussed below), then all such persons would be jointly and severally liable for the tax.

**TAXABLE INUREMENT**

In addition to imposing penalty excise taxes on self-dealing transactions, the bill would also apply to transactions involving "taxable inurement." Under the bill, "taxable inurement" would be defined as a direct or indirect inurement of any part of the net earnings of a public charity described in section 501(c)(3) or an organization described in section 501(c)(4) to the benefit of a disqualified person (as defined above). This penalty excise tax would apply, for example, in cases where a disqualified person receives compensation from the organization. The organization would be subject to a first-tier tax equal to 10 percent of the amount of taxable inurement (e.g., the amount exceeding reasonable compensation). Beneficiaries of taxable inurement would be subject to a first-tier tax equal to 5 percent of the amount of taxable inurement. Organization managers who participate in taxable inurement would be subject to a first-tier tax equal to 2.5 percent of the amount of taxable inurement (subject to a maximum amount of tax of $10,000).

**APPLICATION OF PRIVATE FOUNDATIONS TO SOCIAL WELFARE ORGANIZATIONS**

The bill would amend section 501(c)(4) to provide tax-exempt status to private foundations (including organizations not organized for profit but operated exclusively for the promotion of social welfare, provided that no part of the net earnings of such organization inures to the benefit of any private shareholder or individual). The bill would not alter the present-law standards under section 501(c)(4) governing the tax-exempt status of local associations of employees.

**EFFECTIVE DATE**

The provisions of the bill would be effective for transactions occurring after December 31, 1993.
EXPLANATION OF PROPOSED PUBLIC CHARITY INTERMEDIATE SANCTIONS

Introduction

Recent developments have focused attention on the extent to which absence of intermediate sanctions -- that is, sanctions short of revocation of tax exemption -- undermine the Internal Revenue Service's ability to ensure compliance by public charities with the requirements for tax exemption. Responding to this concern, Independent Sector in July 1993 adopted a policy statement endorsing the establishment of appropriate public charity intermediate sanctions. Pursuant to this policy statement, a special Independent Sector task force has developed the attached legislative proposal. This memorandum presents an explanation of, and rationale for, this proposal.

The proposal adopts the two-level penalty tax mechanism of the existing private foundation rules. For reasons outlined below, it does not, however, adopt the substantive provisions of the private foundation rules related to self-dealing, taxable expenditures, or other prohibited transactions. Instead, the proposed intermediate sanctions would apply to payments of unreasonable compensation and other exchange transactions in which a public charity pays more, or receives less, than fair market value. Both types of transactions are already barred to public charities under the private inurement and private benefit rules of current law. Thus, the proposed rule does not establish any new substantive restrictions on the operations of public charities. Rather, it simply imposes more proportionate and appropriately targeted penalties on violations of the existing requirements for exemption.

I. Current Law

A. Tests for exemption

To qualify for exemption under section 501(c)(3) of the Internal Revenue Code, an organization must be "organized and operated exclusively for charitable ... purposes," and "no part of the net earnings of [the organization may] inure to the benefit of any private shareholder or individual." IRC
$501(c)(3). These statutory requirements have been interpreted and applied by the Internal Revenue Service and the courts in terms of two broad tests, one prohibiting private inurement of a charity's income or assets, and the second prohibiting more than incidental private benefit from its activities.

Private inurement test. The private inurement test prohibits the transfer of any part of the net income of a charity to "any private shareholder or individual." The regulations define this category to include "persons having a personal and private interest in the activities of the organization," and the cases and rulings typically characterize the inurement test as applying to "insiders," that is, persons with some significant degree of control over the actions of the organization.

Prohibited inurement may take a variety of forms. The clearest and most common forms of private inurement involve the payment of unreasonable compensation, or the transfer of charitable assets for less than fair market value. However, the ban on private inurement encompasses any arrangement through which a charity distributes all or part of its net assets to an insider, as, for example, where a charity's officers are compensated based on a percentage of the net revenue from all or part of the charity's operations.

Private benefit test. The private benefit test -- derived from the statutory requirement that an organization be "organized and operated exclusively for charitable purposes" -- requires that an organization not have a "substantial" non-exempt purpose, and that no more than "an insubstantial part of its activities" be in furtherance of such a non-exempt purpose. Thus, unlike the absolute bar on private inurement, the private benefit test recognizes that a charity will often confer some benefit on private persons other than the charity's intended beneficiaries, but requires that this private benefit not be substantial in relation to the organization's charitable purposes and activities.

In recent years, the Service has restated the private benefit standard as requiring that any private benefit arising from a charity's activities be incidental, both qualitatively and quantitatively, to the accomplishment of the charity's exempt

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1 All statutory references are to the Internal Revenue Code of 1986, as amended, and references to regulations are to the Treasury regulations issued pursuant to the Code.

2 Sec. 501(c)(3).

3 Reg. §1.501(a)-1(c).

4 Reg. § 1.501(c)(3)-1(b).
purposes. A private benefit is quantitatively incidental if it is insubstantial when viewed in relation to the public benefit conferred by the activity; it is qualitatively incidental if the benefit to the public cannot be achieved without necessarily benefiting private individuals.

Like private inurement, private benefit may take many different forms. The payment of unreasonable compensation or more than fair market value to unrelated parties, while not inurement because of the absence of an insider relationship, would constitute prohibited private benefit. Other examples of impermissible private benefit include: spending virtually all of an organization’s resources for fund-raising and administrative expenses, with only a nominal amount being used for charitable purposes; leasing property which the charity does not need to confer a benefit on the lessor; or churning a charity’s investments to increase the commission earnings of the charity’s investment manager.

B. Standards for determining reasonableness of compensation and fair market value

The reasonableness of compensation paid by a charity is judged under the same tax law standard applicable to business corporations: reasonable compensation is “only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.” There is a strong presumption that compensation determined through truly arm’s length negotiations is reasonable; indeed, there are few if any cases in which the Service has challenged arm’s length compensation agreements.

Where the parties are not dealing at arm’s length, the key factors considered in evaluating the reasonableness of compensation include: the nature of the employee’s duties; the employee’s background, experience, and knowledge of the business; the amount of time the employee devotes to the business and the employee’s contribution to the accomplishment of the business’ objectives; and the amount paid by similar size organizations in the same area for equally qualified employees for similar services.

The tax law standard for determining fair market value is “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts.”

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5 See, e.g., GCM 37789 (Dec. 18, 1978).
6 Reg. § 1.162-7(b)(3).
7 Reg. § 1.170-1(c)(2).
The Service has consistently refused to issue advance rulings on the reasonableness of compensation and the fair market value of property on the ground that these issues depend on all the facts and circumstances at the time of the transaction, and cannot be conclusively determined by the Service in advance.

C. Absence of intermediate sanctions for public charities

If a public charity pays unreasonable compensation, transfers property for less than fair market value, or otherwise violates either the private inurement or the private benefit tests, the only statutorily prescribed sanction is revocation of tax-exempt status. However, as IRS Commissioner Richardson noted at recent congressional hearings, revocation is often highly disproportionate to the violation, and often punishes the wrong parties by threatening the continued existence of the public charity and its ability to perform needed services for its community while allowing abusers to retain the benefits of their misconduct.

To provide a more proportionate and appropriately targeted response to such public charity violations, the Service has, in recent years, made increasing use of closing agreements, requiring public charities to take various corrective acts as a condition for the Service's agreement to refrain from proposing revocation. However, because these closing agreements are negotiated after the violation and are not publicized, they provide limited guidance, or deterrence, for other organizations.

D. Intermediate sanctions for private foundations

By contrast, since 1969, private foundations have been subject to a comprehensive set of intermediate sanctions contained in Chapter 42 of the Code (IRC §§ 4941-4945). The private foundation rules prohibit self-dealing, excess business holdings, jeopardy investments, and so-called "taxable expenditures," including expenditures for political activity and expenditures for noncharitable purposes, and also require private foundations to meet an annual minimum charitable expenditure test.

Compliance with these rules is enforced through a two level penalty tax system. Violation of any of the provisions triggers a first level tax, equal to 5 or 10 percent of the "amount involved" in the violation, which is imposed on the foundation or, in the case of a self-dealing violation, on the self-dealer. A first level tax of 2 1/2 percent of the amount involved, up to a maximum of $10,000, is also imposed on any foundation manager who knowingly approves the violation, unless the foundation

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property, or purchase services (other than certain personal services) from a disqualified person even if the disqualified person offers terms substantially more favorable than the foundation could obtain on the open market. Thus, the self-dealing rules deny foundations the potential benefit of favorable transactions with well-intentioned disqualified persons in order to protect them from abusive transactions by self-interested insiders.

Congress in 1969 considered this an appropriate trade-off given its judgment that the then quite limited public oversight of foundations had led to widespread abuse.

However, the current situation with respect to public charities differs in three fundamental respects from that which Congress faced in 1969 with respect to private foundations. First, while the examples of abuse cited at the Oversight Subcommittee hearings are disturbing, they fall far short of the perceived widespread pre-1969 abuses in the foundation field. Second, as Congress noted in 1969, public charities are subject to substantially greater public accountability, both by virtue of their generally more public boards and their greater dependence on the public for continuing financial support. Finally, many public charities, particularly small community-based groups, are heavily dependent on support from board members of precisely the sort that would be barred by the self-dealing rules. Any one familiar with the operations of local charities can provide numerous examples: a building contractor on the local YMCA board may offer to renovate the Y's child care center at a substantial discount; board members of a local arts group may provide below market loans to enable the group to weather a financial crisis; or a car dealer on the board of a senior citizen center may offer the group a new van at dealer cost for its meals on wheels program.

Taken together, these three factors underscore the desirability of continuing to evaluate transactions between a public charity and its officers and directors under a fair market value standard rather than to bar such transactions altogether, as under the foundation self-dealing rules.

**Lack of clarity of private inurement and private benefit standards.** Making public charity violations of the private inurement and private benefit rules the standard for imposition of intermediate sanctions would likewise produce highly damaging results. While public charities are subject to these rules under current law, the absence of sanctions short of revocation has, as a practical matter, forced the Service to be restrained in their application of those tests. By contrast, making these inherently imprecise and potentially quite expansive legal standards the trigger for intermediate sanctions would allow the Service to be far more aggressive in applying the inurement and private benefit tests to relatively minor transactions that would never have been seriously considered as a basis
With respect to the inurement test, major uncertainty exists as to the range of individuals treated as insiders, the types of transactions that will be viewed as distributions of net earnings, and the interaction between the inurement and reasonable compensation standards. In recent General Counsel Memoranda, the Service has, for example, attempted to extend the application of the inurement rule by broadening the range of persons treated as "insiders" to include all physicians on a hospital's medical staff, regardless of whether they are in a position to control, or even exert significant influence over, the hospital's operations. Likewise, some Service rulings appear to take the position that certain types of compensation arrangements are per se violations of the inurement rule without regard to whether the amount of compensation actually received under the arrangement is unreasonable in relation to the services rendered. However, existing case law provides substantial support for the contrary position on each of these key points, and both would doubtless become the subject of heated controversy were the inurement test made the basis for imposition of intermediate sanctions.

Similarly, fundamental uncertainties inhere in the private benefit doctrine. Most important, there is no clear analytical framework for determining when private benefit will be considered quantitatively or qualitatively incidental to the public benefit arising from a transaction. For example, in cases involving charitable fund-raising activities with high costs relative to contributions, both the courts and the Service have struggled, with limited success, to define standards for balancing the private benefit derived by fund-raising consultants and others against the benefit to the charity and the public. Moreover, in the context of intermediate sanctions, the uncertainty inherent in the highly subjective nature of this balancing test would be seriously compounded by the difficulty of predicting in advance the success of a particular activity. If, for example, a fund-raising activity were dramatically less successful than a charity anticipated, such that fund-raising costs equaled or even exceeded contributions, could the Service argue that the activity violated the private benefit standard and, therefore, should be subject to intermediate sanctions? The absence of a clear answer to this question is indicative of the fundamental problems inherent in adopting the private benefit test, like the private inurement test, as the basis for public charity intermediate sanctions.

Imposing Intermediate Sanctions on Unreasonable Compensation and Non-Fair Market Value Transactions. By contrast, imposing public charity intermediate sanctions on cases involving payment of unreasonable compensation or non-fair market value transactions would avoid the uncertainty and over-breadth inherent in both of the foregoing options, while at the same time establishing a rule that would reach the great majority of abuse
manager can establish that his action was not willful and was due
to reasonable cause.9

A much more severe second level tax -- equal to 100 or 200
percent of the amount involved -- is imposed on the foundation or
the self-dealer if the violation is not corrected within a
statutorily defined "taxable period." A second level tax is also
imposed on any foundation manager who refuses to agree to all or
part of the required correction. The nature of the required cor-
rection varies depending on the nature of the underlying require-
ment. For example, in the case of an act of self-dealing, the
self-dealer must undo the transaction to the extent possible and
place the foundation in at least as favorable a financial
position as if the self-dealer had adhered to the highest
fiduciary standards.

The Service has the authority to abate the first level tax,
except the first level tax on self-dealers, if the foundation
establishes that the violation was due to reasonable cause and
not to willful neglect, and if the violation was corrected within
the correction period.

This two level penalty tax system is generally regarded as
having provided an effective mechanism for enforcing the private
foundation rules, and Congress has employed the same or similar
intermediate sanctions mechanisms in several provisions governing
lobbying and political activities of public charities.10

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9 A foundation manager is considered to have knowingly
participated in a violation of the private foundation rules only
if: (1) he has actual knowledge of sufficient facts to determine
that the transaction is a violation, (2) he is aware that the
transaction may violated the rules, and (3) he negligently fails
to make a reasonable attempt to ascertain whether the transaction
is a violation, or is in fact aware that it is.

A foundation manager's participation in a violation is will-
ful if it is "voluntary, conscious, and intentional."

Participation in a violation is "due to reasonable cause" if
the foundation manager exercised his responsibility on behalf of
the foundation with ordinary business care and prudence. In this
regarding, foundation managers who rely on a "reasoned written
legal opinion" are considered to have exercised ordinary business
care and prudence, and will not be subject to tax. See, e.g.,
Reg. § 53.4941(a)-1(b).

10 See secs. 501(h), 4912, and 4955.
II. Proposed Public Charity Intermediate Sanctions

A. Defining the Scope of Public Charity Intermediate Sanctions

The most critical decision in designing appropriate public charity intermediate sanctions is defining the range of transactions that would be subject to penalty tax. Three basic alternatives illustrate the possible range of options: (1) adoption of some or all of the substantive requirements of the private foundation rules, (2) making violations of the private inurement and private benefit standards the trigger for intermediate sanctions, or (3) imposing public charity intermediate sanctions on only the most common and clearly defined violations of the private inurement and private benefit rules -- namely, the payment of unreasonable compensation and non-fair market value transactions. For the reasons outlined below, both the first and second options would be unnecessarily burdensome, and would seriously undermine the ability of public charities to accomplish their public service mission. The attached legislative proposal therefore adopts the third alternative.

Over-breadth of the private foundation rules. As noted above, private foundations are subject to a detailed, wide-ranging, and strict set of operational restrictions. These include rules on minimum annual charitable expenditures, permitted business holdings, jeopardy investments, and so-called "taxable expenditures." The recent Oversight Subcommittee hearings have produced essentially no evidence supporting application to public charities of these aspects of the foundation rules. Moreover, while the hearings have produced some disturbing examples of public charity involvement in self-dealing transactions, the unreasonable compensation and non-fair market value transaction rules of the attached proposal would squarely and effectively address these abuses without burdening public charities with the highly restrictive foundation rules which, as explained below, would be seriously damaging to public charities.

The foundation self-dealing rules are designed to create an absolute bar to most economic interaction between a foundation and its "disqualified persons" -- that is, its officers, substantial contributors, and certain related parties. A foundation generally may not borrow money, lease or purchase

\[^{11}\] A case could perhaps be made for subjecting public charities to the component of the taxable expenditure rules that prohibits expenditures for noncharitable purposes. See sec. 4945(d)(5). However, this standard would entail the same imprecision and uncertainty inherent in the private inurement and private benefit tests. As discussed below in relation to those tests (see pp. 12-14), such broad and imprecise rules would be unduly burdensome and are not needed to meet the Service's legitimate enforcement needs.
cases discussed at the recent Oversight Subcommittee hearings.

As noted above, the tax law standards for determining reasonable compensation and fair market value are market-driven standards that play a central role in many aspects of the tax law as applied to taxable as well as tax-exempt organizations. These standards have been the subject of literally thousands of court decisions, and thus their application in various contexts is illuminated by an unusually well-developed case law that would help clarify the application of public charity intermediate sanctions.

These standards are also sufficiently broad to address the Subcommittee's and the Service's principal enforcement concerns. Payment of unreasonable compensation, purchases of property from insiders for more than fair market value, and personal use of charitable assets (which, depending on the context, involves either the payment of additional, potentially unreasonable, compensation or a non-fair market value exchange) are the recurrent themes in the abuse cases presented by the Service and others to the Oversight Subcommittee. All of these cases would be squarely subject to the proposed intermediate sanctions. Cases involving allegedly unreasonable fund-raising costs would likewise be subject to the proposed penalty taxes where the Service could establish that the charity's staff, outside fund-raising counsel, or other parties received more than reasonable compensation for goods or services. While, to be sure, there may be other violations of the private inurement and private benefit that involve neither unreasonable compensation nor non-fair market value transactions, a careful review of the Oversight Subcommittee hearings, as well as of existing case law, indicates that such cases are relatively infrequent and thus provide scant justification for broadening the scope of public charity intermediate sanctions.

B. The unreasonable compensation and non-fair market value rules

The unreasonable compensation and non-fair market value rules are contained in proposed section 4913(d), under which they are referred to collectively as non-fair market value use(s) of the income or assets of a public charity. Under proposed section 4913(d)(1), the payment of unreasonable compensation by a

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12 The proposed rule would not tax charities' fund-raising efforts where the charity paid no more than reasonable compensation for goods or services purchased, even if fund-raising costs equaled or exceeded contributions received. While some such cases may involve abuses in which the fund-raising effort is carried on solely for the benefit of the individuals involved, it is extremely difficult to frame an intermediate sanctions rule that can differentiate these abuse cases from the far more common situation in which a fund-raising effort simply fails to live up to the charity's expectations.
public charity would constitute a taxable "non-fair market value use" regardless of whether the recipient is an insider for purposes of the private inurement rule. Reasonableness of compensation would be determined under the current law standard outlined above (see p. 5).

Proposed section 4913(d)(2) would include within the definition of a "non-fair market value use" any purchase, sale, lease, or other exchange transaction in which the value of the consideration transferred by the charity exceeds the value of the consideration received, unless the charity’s receipt of less than fair market value directly advances an exempt purpose. Thus, purchase of property by a charity for more than fair market value would be a taxable non-fair market value use, while, for example, providing subsidized housing to homeless persons would not be, because the latter directly advances a charitable purpose. Fair market value would be determined under the current law standard outlined above. (See p. 5).

Proposed section 4913(d)(2) contains two de minimis rules designed to ensure that public charities are not burdened by valuation disputes involving small transactions or, in the case of larger transactions, where there is only a relatively small difference between the value of the consideration given by the charity and the value of the consideration it receives. The first of these rules exempts from the definition of "non-fair market value use," and thus from the imposition of intermediate sanctions, any transaction in which the money and other property transferred by the charity has a value of less than $5,000. The second rule provides that intermediate sanctions would apply only where the value of the consideration given by the charity is more than 15 percent less than the value of the consideration which it provides.

Further, section 4913 provides that where a public charity or a person involved in a transaction with a public charity can establish that the terms of a transaction were determined through the arm’s length negotiations, then the burden of proof shifts from the taxpayer to the Service to establish by "clear and compelling evidence that the charity did not receive fair market value. This rule codifies a central principle, noted above, of the existing case law on reasonable compensation and valuation -- namely, that the results of truly arm’s length negotiations are generally accepted as defining fair market value.

C. The Penalty Tax Mechanism

The proposed legislation incorporates the two-level penalty tax mechanism of the private foundation rules discussed above. Thus, any non-fair market value use of the income or assets of a public charity would trigger a first level tax of 5 percent of the "amount involved" (see p. 20 for an explanation of "amount involved") in the non-fair market value use. As explained more fully below, this tax would be imposed on either the persons
benefiting from the non-fair market value use or on the public charity itself. Further, a first level tax of 5 percent of the amount involved, up to a maximum of $10,000, would be imposed on any organization manager who knowingly, willfully, and without reasonable cause "participates" in a non-fair market value use. 13

If the non-fair market value use is not corrected within the prescribed "taxable period," a second level tax of 100 percent of the amount involved would be imposed on either the persons benefiting from the non-fair market value use or on the public charity. Finally, a second level tax equal to 50 percent of the amount involved would be imposed on any organization manager who knowingly, willfully, and without reasonable cause refuses to agree to part or all of the required correction.

**Taxing disqualified persons.** As with the private foundation self-dealing rules, if a non-fair market value use benefits a disqualified person, then both the first and second level tax would be imposed on the disqualified person rather than the organization. The first level tax would be, in essence, a penalty imposed on the disqualified person's breach of his or her fiduciary duty, and the second level tax would be intended to force the disqualified person to make the required correction. Imposing either tax on the charity would inappropriately punish the charity and its intended beneficiaries while allowing the disqualified person to retain the benefit of his or her misconduct.

**Taxing nondisqualified person beneficiaries in certain limited situations.** The proposed rules extend this rationale to nondisqualified persons who benefit from a non-fair market value use under a highly limited, but important set of circumstances: that is where the nondisqualified person knowingly, willfully, and without reasonable cause participates in the non-fair market value use, and thus has demonstrated a clear intent to divert charitable assets to private use. For example, if a professional fund-raiser enters into a contract with a charity knowing that the contract price exceeds the fair market value of the services and, as such, constitutes a non-fair market value use, then the first and second level penalty taxes would be imposed on the fund-raiser rather than the charity. Likewise, if a nondisqualified person leases office space to a charity knowing that the rent exceeds fair market value and, therefore, that the lease is a non-fair market value use, then the lessor, not the charity, would be subject to penalty tax.

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13 As under the private foundation rules, an organization manager who relies on a written legal opinion would not be considered to have knowingly and willfully participated in a non-fair market value use, and thus would not be subject to tax.
This rule will have very limited application since, as noted above, if parties are truly dealing at arm's length -- as will generally be the case in transactions between a charity and a nondisqualified person -- the results of the negotiation are almost universally accepted as defining fair market value and reasonable compensation for tax purposes. However, the rule will have important application in the unusual, but highly troublesome cases in which a person outside the circle of insiders defined as disqualified persons for tax purposes nonetheless obtains sufficient leverage over the operations of a charity to induce the charity to use its resources for his or her benefit. While in such situations the charity's officers and directors have also almost invariably failed to meet their fiduciary duty, the greater culpability often rests with the nondisqualified person beneficiary. Moreover, imposing the penalty taxes on the nondisqualified person beneficiary provides the necessary leverage to force the beneficiary to make the charity whole. By contrast, imposing the penalty tax on the charity would allow the beneficiary to retain the benefits of his or her misconduct while taking resources away from the charity's intended beneficiaries.

**Taxing the public charity.** In cases in which the non-fair market value use benefits neither disqualified persons nor nondisqualified persons who knowingly, willfully, and without reasonable cause participated in the non-fair market value use, then the penalty taxes would be imposed on the charity itself.

**The amount of the penalty tax.** The amount of both the first and second level penalty taxes would be based on "the amount involved" in the non-fair market value use. In the case of payments of unreasonable compensation, the amount involved would be the amount of the excess compensation. In the case of non-fair market value transactions, the amount involved would be the amount by which the value of the consideration given by the public charity exceeds the value of the consideration received.

As under the private foundation self-dealing rules, the first level penalty tax equals 10 percent of the amount involved in the non-fair market value use for each year, or part of a year, in the "taxable period." The taxable period begins on the date on which the non-fair market value use occurs, or, in the case of a continuing non-fair market value use like the leasing of charitable property for less than fair market value, the date on which the non-fair market value use begins. The taxable period ends on the earliest of the date on which the IRS mails a notice of deficiency with respect to the first level tax (generally, at the conclusion of an IRS audit) or assesses the first level tax, or the date on which the correction of the noncharitable act is completed.

Thus, for example, if in 1994 a public charity sells property with a value of $1 million to a disqualified person for a price of $250,000, and this non-fair market value use is not corrected until 1996, then the first level tax on the
disqualified person would equal 5 percent of the amount involved (i.e., 10% of $750,000 = $75,000) for each of the three years in the taxable period (i.e., 1994, 1995, and 1996). In this case, the total first level penalty tax would be $225,000.

**Correction.** Under the proposed rules, in any case in which the non-fair market value use benefits a disqualified person or a nondisqualified person who knowingly, willfully, and without reasonable cause participated in the non-fair market value use, correction would require the beneficiary to place the public charity in a financial position not worse than that in which it would have been in if the beneficiary had adhered to the highest fiduciary standards in dealing with the charity.

For example, if a public charity pays unreasonable compensation to a disqualified person, correction would require the repayment of the excess compensation plus interest. If a public charity purchased property from a disqualified person for more than fair market value, correction would require the disqualified person to repay the excess, with interest.

**Abatement.** As with the private foundation rules, the first level penalty taxes, other than the tax on organization managers, could be abated if the person subject to tax satisfies the IRS that the non-fair market value use was due to reasonable cause and not to willful neglect, and if the event was corrected within the correction period. In contrast to the foundation rules, which do not permit abatement for the first level tax on self-dealers, the proposed rules would permit abatement of taxes imposed on disqualified persons and nondisqualified person beneficiaries of a non-fair market value use on the same basis as abatement of taxes imposed on the public charity.
SEC. 4913. TAXES ON NON-FAIR MARKET VALUE USES OF THE INCOME OR ASSETS OF A PUBLIC CHARITY.

(a) Initial Taxes.--

(1) On the Organization and Certain Beneficiaries of the Non-Fair Market Value Use.--There is hereby imposed on each non-fair market value use of the income or assets of a public charity (as defined in subsection (d)), a tax equal to 10 percent of the amount involved with respect to the non-fair market value use for each year (or part thereof) in the taxable period. If the non-fair market value use benefits a disqualified person, or a nondisqualified person who participates in the non-fair market value use knowing it to be a non-fair market value use (unless such participation is not willful and is due to reasonable cause), the tax imposed by this paragraph shall be paid by such person. Otherwise, the tax imposed by this paragraph shall be paid by the public charity.

(2) On Management.--In any case in which a tax is imposed by paragraph (1), there is hereby imposed on the participation of any organization manager in the non-fair market value use, knowing that it is a non-fair market value use, a tax equal to 5 percent of the amount involved with respect to the non-fair market value use for each year (or part thereof) in the taxable period, unless such participation is not willful and is due to reasonable cause. The tax imposed by this paragraph shall be paid by any organization manager who participated in the non-fair market value use.

(b) Additional Taxes.--

(1) On the Organization and Certain Beneficiaries of the Non-Fair Market Value Use.--In any case in which an initial tax is imposed by subsection (a)(1) on a non-fair market value use of the income or assets of a public charity and the non-fair market value use is not corrected within the taxable period, there is hereby imposed a tax equal to 100 percent of the amount involved. With respect to any non-fair market value use, the tax imposed by this paragraph shall be paid by the same person or persons subject to tax under subsection (a)(1).
(2) On Management.—In any case in which an additional tax is imposed by paragraph (1), if an organization manager refused to agree to part or all of the correction, there is hereby imposed a tax equal to 50 percent of the amount involved. The tax imposed by this paragraph shall be paid by any organization manager who refused to agree to part or all of the correction.

(c) Special Rules.—

(1) Joint and Several Liability.—If more than one person is liable under any paragraph of subsection (a) or (b) with respect to any non-fair market value use, all such persons shall be jointly and severally liable under such paragraph with respect to such non-fair market value use.

(2) $10,000 Limit For Management.—With respect to any one non-fair market value use of the income or assets of a public charity, the maximum amount of the tax imposed by subsection (a)(2) shall not exceed $10,000, and the maximum amount of the tax imposed by subsection (b)(2) shall not exceed $10,000.

(d) Non-Fair Market Value Use of Income or Assets.—

(1) In General.—For purposes of this section, the terms "non-fair market value use" and "non-fair market value use of the income or assets of a public charity" mean any direct or indirect—

(A) payment of unreasonable compensation by a public charity; or

(B) sale, exchange, leasing, or lending of property, or furnishing of goods, services, or facilities, by or to a public charity, if the value of the consideration given by the public charity exceeds the value of the consideration received by the public charity, unless the charity's receipt of less than fair market value directly advances an exempt purpose.

(2) De Minimis Rule.—No transaction shall be considered a non-fair market value use unless the value of the consideration given by the public charity is greater than $5,000 and exceeds by more than 15 percent the value of the consideration received by the public charity.

(3) Arm’s Length Negotiations. Where it is established that the terms of a transaction were determined through arm’s length negotiation, the burden of proof shall be upon the Secretary to establish, by clear and convincing evidence, that the transaction was a non-fair market value transaction.
(e) Other Definitions.--

(1) Taxable Period.--The term "taxable period" means, with respect to any non-fair market value use, the period beginning with the date on which the non-fair market value use occurs and ending on the earliest of--

(A) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a)(1) under section 6212,

(B) the date on which the tax imposed by subsection (a)(1) is assessed, or

(C) the date on which correction of the non-fair market value use is completed.

(2) Amount Involved.--The term "amount involved" means--

(A) with respect to a non-fair market value use described in subsection (d)(1), the excess compensation; and

(B) with respect to a non-fair market value use described in subsection (d)(2), the amount by which the value of the consideration given by the public charity exceeds the value of the consideration received.

(3) Correction.--The terms "correction" and "correct" mean:

(i) with respect to any non-fair market value use which benefits a disqualified person, or a nondisqualified person who participated in the non-fair market value use knowing it to be a non-fair market value use (unless such participation is not willful and is due to reasonable cause), placing the public charity in a financial position not worse than that in which it would be if the disqualified person or nondisqualified person beneficiary were dealing under the highest fiduciary standards; and

(ii) with respect to any non-fair market value use, the adoption and implementation by the public charity of policies and procedures which provide reasonable protection against a recurrence of the non-fair market value use.

(4) Public Charity.--The term "public charity" means any organization described in paragraphs (1), (2), or (3) of section 509(a).

(5) Organization Manager.--The term "organization manager" means--
(A) any officer, director, or trustee of the organization (or individual having powers or responsibilities similar to those of officers, directors, or trustees of the organization), and

(B) with respect to any act (or failure to act), any employee having authority or responsibility with respect to such act (or failure to act).

(6) Disqualified Person.—The term "disqualified person" has the meaning given to such term by section 4946(a), except that the terms "private foundation" and "foundation manager" shall be replaced by the terms "public charity" and "organization manager," respectively. However, no person shall be treated as a disqualified person by virtue of contributions made to a public charity prior to January 1, 1994 unless the Secretary can establish, by clear and convincing evidence, that such person is a substantial contributor within the meaning of section 507(d)(2).

SEC. 4962. ABATEMENT OF FIRST TIER TAXES IN CERTAIN CASES

(a) General Rule.—If it is established to the satisfaction of the Secretary that

(1) a taxable event was due to reasonable cause and not to willful neglect, and

(2) such event was corrected within the correction period for such event,

then any qualified first tier tax imposed with respect to such event (including interest) shall not be assessed and, if assessed, the assessment shall be abated and, if collected, shall be credited or refunded as an overpayment.

(b) Qualified First Tier Tax.—For purposes of this section, the term "qualified first tier tax" means any first tier tax imposed by chapter 41 or subchapter A or C of this chapter, except that such term shall not include the tax imposed by section 4941(a)(relating to initial tax on self-dealing).

(c) Special Rule for Tax on Political Expenditures of Section 501(c)(3) Organizations.—In the case of the tax imposed by section 4955(a), subsection (a)(1) shall be applied by substituting "not willful and flagrant" for "due to reasonable cause and not to willful neglect."

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1 Proposed changes in sections 4962 and 4963 are underscored.
SEC. 4963. DEFINITIONS.

(a) First Tier Tax.--For purposes of this subchapter, the term "first tier tax" means any tax imposed by subsection (a) of section 4912, 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4955, 4971, or 4975.

(b) Second Tier Tax.--For purposes of this subchapter, the term "second tier tax" means any tax imposed by subsection (b) of section 4912, 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4955, 4971, or 4975.

(c) Taxable Event.--For purposes of this subchapter, the term "taxable event" means any act (or failure to act) giving rise to liability for tax under section 4912, 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4955, 4971, or 4975.

(d) Correct.--For purposes of this subchapter--

(1) In General.--Except as provided in paragraph (2), the term "correct" has the same meaning as when used in the section which imposes the second tier tax.

(2) Special Rules.--The term "correct" means--

(A) in the case of the second tier tax imposed by section 4942(b), reducing the amount of the undistributed income to zero,

(B) in the case of the second tier tax imposed by section 4943(b), reducing the amount of the excess business holdings to zero, and

(C) in the case of the second tier tax imposed by section 4944, removing the investment from jeopardy.

(e) Correction Period.--For purposes of this subchapter--

(1) In General.--The term "correction period" means, with respect to any taxable event, the period beginning on the date on which such event occurs and ending 90 days after the date of mailing under section 6212 of a notice of deficiency with respect to the second tier tax imposed on such taxable event, extended by--

(A) any period in which a deficiency cannot be assessed under section 6213(a) (determined without regard to the last sentence of section 4961(b)), and

(B) any other period which the Secretary determines is reasonable and necessary to bring about correction of the taxable event.
(2) Special Rules for when Taxable Event Occurs.-- For purposes of paragraph (1), the taxable event shall be treated as occurring--

(A) in the case of section 4942, on the first day of the taxable year for which there was a failure to distribute income,

(B) in the case of section 4943, on the first day on which there are excess business holdings,

(C) in the case of section 4971 on the last day of the plan year in which there is an accumulated funding deficiency, and

(D) in any other case, the date on which such event occurred.
PREPARED STATEMENT BY LESLIE B. SAMUELS, ASSISTANT TREASURY SECRETARY FOR TAX POLICY, BEFORE HOUSE WAYS AND MEANS OVERSIGHT SUBCOMMITTEE HEARING ON TAX COMPLIANCE BY CHARITABLE ORGANIZATIONS MARCH 18, 1994

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the Administration's views on the important issue of the compliance with the tax laws by public charities. This Subcommittee held hearings on June 15, 1993, and August 2, 1993, regarding the administration of and compliance with the tax laws applicable to public charities exempt from tax under section 501(c)(3) of the Internal Revenue Code (the "Code"). The first hearing focused on the difficulties encountered by the Internal Revenue Service (the "IRS") in enforcing the standards for tax exemption. The second hearing provided illustrations of the ways in which certain charitable organizations are misusing their resources. Together, the hearings provide a solid foundation for the conclusion that carefully-targeted reform measures are needed to improve compliance with tax laws by public charities. We command the Subcommittee for demonstrating the need for reform.

Working with the staffs of the Subcommittee, the Ways and Means Committee, and other appropriate Committees, the Administration has developed a proposal that addresses the issues raised by the Subcommittee's prior hearings. Also, we are aware of other proposals that relate to these issues. Consequently, to facilitate the Subcommittee's consideration of solutions to this important problem, I would like to present our proposal to improve compliance with the tax laws by tax-exempt organizations. After presenting our proposal, we will continue to work with you and other appropriate Committee in considering necessary legislative action.

I will begin by summarizing the relevant standards for exemption under current law and the difficulties encountered by the IRS in enforcing these standards. Next, I will describe the detailed regulatory regime that the current law imposes on private foundations. The private foundation rules provide a useful frame of reference in considering measures to improve compliance by other tax-exempt organizations. As I will explain, however, we believe that it would be inappropriate to extend to other organizations the detailed regulatory restrictions that apply to private foundations. Finally, I will describe the Administration's proposals for improving compliance with the tax laws by tax-exempt organizations.

I. RELEVANT STANDARDS FOR EXEMPTION UNDER CURRENT LAW

Section 501(c)(3) organizations. Section 501(a) of the Code exempts from income tax any organization described in section 501(c). Section 501(c)(3) refers to organizations that are organized and operated exclusively for certain purposes, including religious, charitable, or educational purposes. In addition to being organized and operated for a specified exempt purpose, an organization seeking to qualify for exemption under section 501(c)(3) must comply with statutory limitations on inurement as well as lobbying and political activities. In particular, an organization qualifies for exemption under section 501(c)(3) only if (1) no part of its net earnings inures to the benefit of a private shareholder or individual, (2) no substantial part of its activities consist of carrying on propaganda or otherwise attempting to influence legislation, and (3) it does not participate or intervene in any political campaign on behalf of, or in opposition to, a particular candidate.

Section 501(c)(4) organizations. Section 501(c)(4) of the Code refers to two categories of organizations. The first category of organizations that qualify for exemption under that section includes "civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare." Among the more common of these social welfare organizations are public interest organizations, lobbying affiliates of charitable organizations exempt under section 501(c)(3), and health maintenance organizations. The second category of organizations that qualify for exemption under section 501(c)(4) includes certain "local associations of employees" of limited membership. These employee associations qualify for exemption, however, only if they devote their net earnings exclusively to charitable, educational, or recreational purposes.

II. DIFFICULTY OF ENFORCING CURRENT LAW STANDARDS FOR EXEMPTION AND THE NEED FOR REFORM

Current law provides no sanction for violations of the standards for tax exemption short of revocation of an organization's exemption. As the Commissioner of Internal Revenue, Margaret Milner Richardson, testifed at the Subcommittee's hearing on June 15, 1993, the absence of a sanction short of revocation has created significant difficulties for the IRS in enforcing the standards for tax exemption. Since revocation is a severe sanction, it may be disproportional to the violation in issue.

Assume, for example, that a large university pays one of its officers excessive compensation. Although the resulting "inurement" would violate one of the standards for tax exemption, revoking the university's exemption could be an inappropriate response. It could adversely affect the entire university community: employees, students and area residents. Moreover, the officer would be able to retain the excessive benefits received from the university. Despite the potential inappropriateness of revoking an organization's tax exemption in this type of case, it is the only sanction provided under current law. Thus, the IRS could be faced with the difficult choice of revoking the organization's exemption or taking no enforcement action.

The cases discussed at the August 2, 1993 hearing which involved misuses of resources by tax-exempt organizations illustrate the difficulties the IRS has had in enforcing the standards for exemption. Although we do not believe that
the cases of noncompliance are widespread or representative of the charitable community as a whole, these cases cause us concern.

The cases of misused resources should also concern the vast majority of tax-exempt organizations that fully comply with the standards for exemption. These types of cases have shaken the public's confidence in charitable organizations. Consequently, charities should be interested in reducing the occurrence of abuses, to prevent the further erosion of the reputation of the charitable community as a whole. In recognition of this fact, at least one large coalition of nonprofit organizations, INDEPENDENT SECTOR, has made proposals to improve the performance and accountability of public charities.

The evidence the Subcommittee and its staff have compiled should not be dismissed because it is "anecdotal." The cases studied by the Subcommittee and its staff demonstrate that the system is not working as it should. These cases simply should not occur. When they do, the notoriety they receive undermines the public's confidence in the charitable community and in the tax system. Consequently, we believe that a proposal for carefully targeted intermediate sanctions is appropriate at this time.

Our belief is that the cases of abuse the Subcommittee has studied are not representative of the charitable community as a whole should not forestall proposals for needed reforms. It does, however, guide us in determining the scope of the appropriate response. We believe that it would be unjustified to pursue now sweeping new regulation of public charities on the basis of the cases that have been the subject of Congressional and media scrutiny. In particular, as explained in the following section, extending to public charities the detailed regulatory regime that applies to private foundations would be inappropriate. Instead, the record compiled by the Subcommittee calls for a measured response, with sanctions targeted at the specific types of abuses the Subcommittee has identified.

III. Regulatory Provisions Applicable to Private Foundations

Current law imposes a detailed regulatory regime on a subset of section 501(c)(3) organizations referred to as private foundations. In general, private foundations include all section 501(c)(3) organizations other than churches and church-related organizations, schools, hospitals and medical research organizations, and certain publicly-supported organizations.

Tax on self-dealing. Among the regulatory provisions that apply to private foundations is an excise tax on "self-dealing." Subject to narrow exceptions, any sales, leases, loans or other transfers between a private foundation and a "disqualified person" are acts of self-dealing. See generally Code §4941(d). The payment of reasonable compensation to a disqualified person, however, is not self-dealing. Further, if a private foundation makes goods, services or facilities available to the public, providing them to a disqualified person on the same terms does not result in self-dealing.

A person is a disqualified person in relation to a private foundation if the person is a substantial contributor to the foundation, a foundation manager, or a person or entity related to either. See generally Code §4946. Foundation managers include the foundation's officers, directors, or trustees, or those with similar responsibilities.

The tax on self-dealing follows a two-tiered approach. If an act of self-dealing occurs, the disqualified person and any foundation manager who knowingly participated in the self-dealing are liable for initial taxes of 5 and 2.5 percent of the "amount involved," respectively, for each year in the "taxable period." The taxable period for an act of self-dealing begins when the act occurs and ends with the later of (i) the mailing of a notice of deficiency for the initial tax, (ii) imposition of the initial tax, or (iii) correction of the act of self-dealing.

If the act of self-dealing is not "corrected" within the taxable period, the disqualified person and foundation manager are liable for a second, more severe tax (i.e., 200 and 50 percent of the amount involved, respectively). The liability of a foundation manager for either the initial or second tier tax is limited to $10,000. Correction of an act of self-dealing involves undoing the transaction to the extent possible and, in any event, placing the private foundation in a financial position no worse than it would have been had the disqualified person acted in accordance with the highest fiduciary standards.

Tax on taxable expenditures. Section 4945 of the Code imposes a separate two-tiered excise tax on "taxable expenditures." Taxable expenditures include political or lobbying expenditures, certain grants to organizations other than public charities, and any other expenditures for noncharitable purposes. The taxes on taxable expenditures apply to the foundation itself and to any foundation manager who agreed to the expenditure. The initial tax on the foundation is 10 percent of the taxable expenditure. The initial tax on the manager is 2.5 percent of the taxable expenditure, subject to a limit of $5,000. If the taxable expenditure is not corrected within the taxable period, the foundation is subject to an additional tax of 10 percent of the taxable expenditure, and the manager is subject to a tax of 5 percent of the taxable expenditure.

Abatement of taxes. If an event that gave rise to an excise tax under the private foundation rules is corrected within a prescribed "correction period," the second tier tax is waived, and any tax collected is credited or refunded. The correction period begins when the taxable event occurs and generally ends (subject to certain extensions) 90 days after the date of mailing of a notice of deficiency for a second tier tax.

If the taxable event was due to reasonable cause and not willful neglect, the first tier tax is waived, and any tax collected is credited or refunded. The abatement of first tier tax, however, does not apply to a tax on self-dealing.

Termination of private foundation status. In enacting the private foundation rules, Congress was concerned that a private foundation not be allowed to receive deductible contributions and be exempt from tax on its income, and then terminate its section 501(c)(3) status after building up its endowment, so that it would be free to use its resources for non-charitable purposes. To prevent this result, section 507 of the Code provides that an organization's status as a private foundation subject to the detailed regulatory restrictions terminates only when the organization pays an exit tax equal to the lesser of the value of its net assets or the cumulative, aggregate tax benefit resulting from its qualification for exemption under section 501(c)(3). The aggregate tax benefit is computed taking into account not only the tax the foundation would have paid on its own income had it not been exempt, but also the additional tax that substantial contributors to the foundation would have paid had their contributions not been deductible. The Secretary may abate the exit tax, however, to the extent that the foundation distributes its net assets to one or more other charitable organizations in existence for at least 60 calendar months.

Rationale for distinction between public charities and private foundations. When Congress enacted the reg-

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ulatory provisions applicable to private foundations in 1969, it declined to extend those provisions to churches, hospitals, and other “public charities” on the grounds that they are subject to public scrutiny that reduces the risk of misconduct. The distinction drawn by Congress in 1969 between public charities and private foundations remains valid today. Therefore, full extension of the private foundation rules to public charities would be inappropriate and could hinder their ability to perform legitimate charitable activities. For example, the self-dealing rules would prevent a public charity from engaging in transactions with insiders that are favorable to the charity, such as receiving a low-interest loan from an insider, or purchasing of goods or services from an insider at a substantial discount.

Although we are concerned about the level of compliance by certain public charities with the standards for tax exemption, these concerns are not as great as those that led to the enactment of the private foundation rules in 1969. Public charities continue to face public accountability that reduces the risk that they will use their resources in ways that are inconsistent with their tax-exempt purposes. The documented cases of noncompliance by public charities, however, demonstrate a need to improve the accountability of the public to serve in the “watchdog” role envisioned for it in 1969. As I will explain later, our proposal includes (i) an excise tax targeted to types of transactions where significant abuses may occur, and (ii) disclosure measures that would provide the public with better access to more information regarding public charities. These measures, taken together, should adequately improve compliance by public charities and improve the public’s ability to hold charities accountable.

IV. Proposals to Improve Compliance by Tax-Exempt Organizations

The Administration’s proposal to improve compliance by tax-exempt organizations includes a new excise tax and several measures that would strengthen the disclosure requirements that apply to tax-exempt organizations. The excise tax is targeted at the types of abuses that have generated concern and would provide a substantial deterrent to such abuses. The new disclosure requirements would increase the information regarding tax-exempt organizations available to the public. This would improve the public’s ability to hold these organizations accountable for the ways in which they use their resources.

A. Tax on “Excess Benefits”

Transactions subject to tax. The excise tax would apply to any “excess benefit” provided to an insider by an organization exempt from tax under section 501(c)(3) or 501(c)(4). The excise tax would not apply, however, to benefits provided by a private foundation to which the excise taxes described in the preceding section are applicable.

An excess benefit is the excess of the value of any benefit provided by the organization over the consideration received by the organization in return for the benefit. The consideration received by the organization may include services provided by the insider. The tax would apply to two types of transactions: the payment of unreasonable compensation by an organization or a non-fair market value transfer in which an insider pays inadequate consideration for property transferred, leased, licensed or loaned by the organization, or the organization pays excessive consideration for property transferred, leased, licensed or loaned by the insider.

The insiders who would be subject to the tax include (i) the officers, directors, and trustees of an organization and (ii) those otherwise in a position to exercise substantial influence over the organization’s affairs. Excess benefits provided to members of the insider’s family or entities in which an insider or family members have significant direct or indirect beneficial interests would be treated as provided on behalf of the insider; thus the insider would be subject to tax on these benefits. An excess benefit provided to a former insider would be subject to tax if the relevant decision-making body of the organization, formally or informally, approved the benefit when the recipient was an insider.

Although the Subcommittee’s hearings focused on misuses of resources by public charities exempt from tax under section 501(c)(3), our proposed excise tax applies to benefits provided by organizations exempt under section 501(c)(4) as well. The restructuring of the health care market expected to result from health reform could provide greater opportunities for insiders of health care organizations, including health maintenance organizations exempt under section 501(c)(4), to divert to the insiders’ own benefit the resources of these organizations. Extending the proposed excise tax to benefits provided by section 501(c)(4) organizations would deter insiders from seeking to take advantage of the restructuring of HMOs and other health care organizations. If, for example, the board of an HMO exempt under section 501(c)(4) cause the HMO to sell its assets at a bargain price to a for-profit corporation controlled by the board members, the transaction would result in an excess benefit subject to the proposed excise tax.

Factual determinations. The reasonableness of compensation or the adequacy of consideration would be determined based on all of the facts and circumstances. The reasonableness of compensation is a question of relevance to taxable businesses, because section 162 of the Code allows a deduction for compensation only to the extent that it is reasonable. Those factors relevant in determining the reasonableness of compensation for purposes of section 162 would also be relevant for purposes of the proposed excise tax. These factors include the nature of the insider’s duties, his background and experience, and the time he devotes to the organization, the size of the organization, general and local economic conditions, and the amount paid by similar organizations to those who perform similar services.

The approval of the compensation or transfer by an independent governing body of the organization would weigh in favor of finding reasonableness or adequate consideration. The weight to be given to this factor would depend on the circumstances. For example, approval by a nominally independent governing body may be given little weight if the governing body is comprised of close friends of the organization’s founder and president who routinely endorse proposals made by that person. On the other hand, approval by a governing body would be given greater weight if the governing body is truly independent and has a demonstrated record of taking its fiduciary responsibilities seriously.

Determinations of the reasonableness of compensation would be made in accordance with the procedures that govern the resolution of any factual question involved in the application of a tax rule. Therefore, taxpayers who disagree with an IRS determination of unreasonable would have recourse to the normal review procedures, including, as necessary, administrative appeals and judicial proceedings.

Benefits provided to an insider can be justified as reasonable compensation only if the organization in fact provided the benefits as compensation for services. The determination of whether a benefit was intended to be compensatory would be made based on all the facts and circumstances. The relevant facts would include whether the appropriate
decision-making body approved the transfer as compensation in accordance with established procedures and whether the organization and the recipient reported the transfer as compensation on the relevant forms (i.e., the organization's Form 990, the Form W-2 provided by the organization to the individual, and the individual's Form 1040). If a non-fair market value transfer is not made as compensation for services, it would be subject to the new excise tax even if the insider's compensation would have been reasonable had the transfer been compensatory.

**Imposition of tax.** The tax on excess benefits would follow the two-tiered format of the excise taxes on private foundations. If an organization provides an excess benefit to an insider or a related person or entity, the insider would be subject to an initial tax of 25 percent of the amount of the excess benefit—that is, the portion of compensation that is unreasonable, or the difference between the price paid and the fair market value of property transferred. If the insider does not repay the excess benefit with appropriate interest within a prescribed period, the insider would be subject to a second tax equal to 200 percent of the excess benefit. If the insider repays the excess benefit within a prescribed correction period, the second tier tax would be waived or refunded. The initial tax would be waived or refunded only if the excess benefit was provided due to reasonable cause.

Under established tax benefit principles, repayment of an excess benefit by an insider would be deductible only to the extent that the receipt of the excess benefit increased the insider's taxable income for a prior year. Payment of the tax itself would be nondeductible.

If a manager of an organization approves a transaction knowing that results in an excess benefit, the manager would be subject to a tax of 10 percent of the excess benefit, up to a maximum of $10,000. To ensure that the manager bears the economic burden of the tax, any payment or reimbursement by the organization of a tax imposed on a manager would itself be treated as an excess benefit provided to the manager. Thus, the manager would be subject to the excess tax as an insider on such payment or reimbursement.

**Relationship between excess tax and revocation.** The excess tax on excess benefits would be the sole sanction available in those cases in which the excess benefit does not rise to the level that it calls into question whether the organization is a charitable organization. As discussed above, in these cases, revocation is an inappropriate sanction because it is unduly severe and would adversely affect the beneficiaries of the organization's charitable activities. Revocation is an appropriate sanction only when the organization no longer operates as a charitable organization.

If an organization provides an excess benefit that is so egregious that the organization is not viewed as a charitable organization, the proposed excise tax would apply and, in addition, the organization would be subject to revocation of its exemption. To accomplish this result, the excise tax would apply to benefits provided by an organization even after it loses its exemption. Otherwise, an insider who received a benefit that caused the organization to lose its exemption could avoid the tax by “correcting” the benefit and then causing the organization to repay the benefit to the insider when the organization is no longer exempt.

In determining the circumstances in which the excise tax should continue to apply to benefits provided by an organization that loses its tax exemption, the private foundation rules provide a useful analogy with the rules of section 507 related to the termination of private foundation status. Our proposal includes rules similar to those of section 507, under which the excise tax would apply to benefits provided by a formerly exempt organization prior to the time that the organization either transfers its net assets to another qualifying exempt organization or pays an exit tax. The exit tax would be computed in the same manner as the tax provided in section 507(c) (i.e., the lesser of net asset value or the cumulative, aggregate tax benefit from qualification under section 501(c)(3) or (4)). Thus, the assets of an organization, to the extent attributable to its exemption under section 501(c)(3) or (4), could not be diverted to the benefit of insiders after the organization loses its exemption.

We envision having customary authority to promulgate such regulations as may be necessary or appropriate to carry out the purposes and prevent avoidance of the excise tax.

**Example.** Perhaps the best way to illustrate our proposed excise tax is to describe how it would apply to one of the cases addressed in the Subcommittee's hearings last year. For purposes of illustration, I will use the case described on page 147 of the hearing record (Serial 193-59). This case involves a section 501(c)(3) organization that provides health care in a clinic type setting. The organization's board of directors is controlled by the CIE and a small number of persons with whom the CIE or the organization itself have substantial business dealings.

The total compensation package of the CEO exceeded $1 million. The organization also made substantial credit card payments and cash disbursements for personal expenditures, including liquor, china, perfume, crystal, theater and airline tickets.

The CEO's compensation would be an excess benefit, subject to the excise tax, to the extent that it were determined to be unreasonable. The reasonableness of the CEO's compensation would be assessed looking at all of the facts and circumstances, including the nature of the CEO's duties and the compensation paid by similar organizations to those who perform similar duties. The means by which the organization determined the compensation it paid the CEO would also be relevant. In this case, although the organization's board presumably approved the CEO's salary, the facts suggest that the board is not truly independent. The CEO appears to have substantial influence over the board. Therefore, even assuming that the board approved the compensation, that fact would be given very little weight in this particular case.

If a portion of the CEO's compensation were determined to be unreasonable, the CEO would be subject to a tax of 25 percent of the unreasonable portion of the compensation. In addition, any manager of the organization who approved the compensation knowing that it was unreasonable would be subject to a tax of 10 percent of the excess benefit, up to a maximum of $10,000. If the CEO did not repay the excessive portion of the compensation within a prescribed period, the CEO would be subject to an additional tax equal to 200 percent of the excess benefit.

In determining the reasonableness of the CEO's compensation, the payments of personal expenses would be treated as compensation only if the organization made the payments in compensation for the CEO's services. The compensatory nature of the payments could be demonstrated, for example, by board approval of the payments as compensation or by the reporting of these payments as compensation on the relevant Forms 990, W-2 and 1040.

The facts in this case indicate that the payments of personal expenses were not part of the CEO's authorized compensation. If the payments were not compensatory, the
full amount of the payments would be excess benefits, subject to the proposed tax. The tax would apply even if the CEO's total compensation would have been reasonable had these expenditures been included in his compensation. If the payments were not in fact compensatory, they could not be justified as reasonable compensation.

B. Penalties for Failure to Meet Form 990 Filing Requirements

As previously noted, public charities are not subject to the detailed regulatory regime that applies to private foundations because public scrutiny reduces the risk of misconduct by public charities. The effectiveness of public scrutiny depends on the availability of relevant information about public charities. The primary vehicle for this information is the Form 990, which most tax-exempt organizations must file annually. The Administration's proposal includes several measures to improve both the information provided on the Form 990 and the availability of that information to the public.

The Form 990 can serve as an effective vehicle for providing public oversight of charitable organizations only if those organizations file timely and accurately. As the Subcommittee's hearings have demonstrated, compliance with the filing requirement has been poor in many instances. A number of organizations file incomplete or inaccurate Forms 990.

Noncompliance with the Form 990 filing requirement may be largely attributable to the relatively low applicable penalties. The penalty under current law for a failure to file a timely, complete and accurate Form 990 is only $10 for each day during which the failure continues. Further, the maximum penalty for any one return cannot exceed the lesser of $5,000 or 5 percent of the gross receipts of the organization for the year.

To improve compliance with the Form 990 filing requirement, the Administration's proposal would increase the penalty for a failure to file a timely, complete and accurate Form 990 from $10 to $100 a day for organizations with gross receipts in excess of $1 million for the year, subject to a maximum of $50,000 for any one return. For organizations with gross receipts of $1 million or less, the penalty would be increased to $20 a day, with the maximum for any one return limited to the lesser of $10,000 or 5 percent of the gross receipts of the organization for the year.

C. Provision of Copies of Return, Applications for Exemption

The Form 990 must be readily available to the public if it is to effectively facilitate public oversight of charitable organizations. Current law requires an organization other than a private foundation to make available for public inspection those portions of its Form 990 that do not include information regarding contributors to the organization. The form must be available at the organization's principal office and at any regularly-maintained regional or district office that has more than 3 employees. The organization must also make available copies of any application for exemption filed with the IRS, any papers submitted in support of the application, and any letter or document issued by the IRS in response to the application. An organization that fails to make available a return or application for exemption is subject to a penalty under section 6652(c)(1)(C) of $10 for each day on which the failure continues, subject to a maximum of $8,000 for failures with respect to any one return. If the failure is willful, however, a separate penalty of $1,000 applies with respect to each return or application for exemption.

Public oversight of charitable organizations is significantly hindered by the fact that interested members of the public must travel to an office of an organization to inspect its Form 990 and any application for exemption. Further, organizations are required only to allow inspection of the relevant forms, they are not required to provide copies of the forms to interested members of the public.

To improve the public's access to relevant information regarding exempt organizations, the Administration's proposal requires these organizations to provide copies of their Forms 990 and applications for exemption and related materials to any person who requests these documents and pays a reasonable fee to cover copying and mailing costs. The Secretary of the Treasury would promulgate regulations regarding reasonable fees that could, for example, specify a per page limit. Organizations would also be required to take measures to ensure that the public knows of the availability of their Forms 990. In particular, an organization would be required to include in its fundraising solicitations an express statement regarding the availability of its Form 990.

The Administration’s proposal would increase the penalty under section 6652(c)(1)(C) from $10 to $20 per day. The maximum penalty per return would be increased from $5,000 to $10,000.

We intend to develop rules to protect organizations from the burdens of complying with requests for documents made as part of an organized harassment campaign. One approach to this issue would be to apply a limit on the number of requests that the organization would be required to fulfill within a given period. We would appreciate the views of the Subcommittee regarding appropriate means of addressing this issue.

D. Additional Information to be Provided on Form 990

The Form 990 should provide the public with all information related to the consistency of the organization's activities with the standards for tax exemption. Both current law and the Administration's proposal include excise taxes on activities inconsistent with the standards for exemption. As described above, the Administration's proposal includes a tax on excess benefits that would generally violate the prohibition on inurement. Under current law, sections 4911 and 4912 impose taxes on excess and disqualifying lobbying expenses. To ensure that the public has access to information regarding transactions that give rise to these excise taxes, the Administration's proposal requires an organization to report on its Form 990 the payment of tax imposed by section 4911 or section 4912, and transactions involving the payment of excess benefits subject to the proposed excise tax, including excess benefits for which the tax was asserted but then waived due to repayment.

The Form 990 should also provide interested members of the public with information regarding significant changes in the management of an organization. Therefore, the Administration's proposal would require an organization to report on its Form 990 changes in the membership of its governing board, and a change in the identity of the certified public accountant firm retained by the organization to examine its books and records.

Our colleagues at the IRS have been working with the Subcommittee staff to identify means by which the Form 990 may be improved. As a result of these efforts, the IRS has already made several changes to the Form, including the separate listing of cash and noncash contributions and
expenditures, and expanded information about transactions involving key employees or related persons. In addition, the IRS is studying the issue of the reporting of fundraising fees and activities. We welcome any further recommendations that the Subcommittee may have in this area.

E. Disclosed of Nonexempt Status

We propose one additional measure that, although not directly related to compliance with the standards for tax exemption, would improve compliance with the provisions regarding the deductibility of charitable contributions. Section 170 allows a deduction for contributions or gifts to or for the use of certain types of organizations, including those that are exempt under section 501(c)(3). Many organizations that are tax-exempt, however, are not eligible to receive tax-deductible contributions. Prior to 1988, tax-exempt or other nonprofit organizations were not required to disclose to potential contributors that contributions to these organizations are nondeductible. Section 6113 of the Code, enacted as part of the Revenue Act of 1987, requires such a disclosure by tax-exempt organizations ineligible to receive deductible contributions. Contributions could mistakenly believe, however, that they can deduct contributions to any nonprofit organization. Therefore, the Administration's proposal would amend section 6113 so that a nonprofit organization that refers to itself as such in a fundraising solicitation would have to disclose that contributions to the organization are not deductible.

Mr. Chairman, these are the measures the Administration proposes to improve compliance with the tax laws by public charities and certain other tax-exempt organizations. Our proposal is a measured response to the two concerns that have caused concern. The proposed excise tax on excess benefits would deter insiders of an organization from using their positions of influence to receive unreasonable compensation or to cause the organization to enter into non-fair market value transfers. In addition, our proposed disclosure measures would significantly improve the public's ability to hold exempt organizations accountable for the ways in which they use their resources. On the other hand, our proposals would not interfere with legitimate exempt activities.

The Administration's proposal would substantially reduce the occurrence of the types of abuses that have caused concern, thereby restoring confidence in the charitable community. These are goals shared by all, including the vast majority of charitable organizations that devote their resources to worthy charitable purposes. Therefore, we ask the members of the Subcommittee and the charitable community to support our proposal and help us achieve these important goals.

Mr. Chairman, this concludes my prepared remarks. I am available at this time to answer any questions you or the other members may have regarding the Administration's proposal.

A substantial contributor to a private foundation is a person who contributed or bequeathed to the foundation an aggregate amount that exceeds the greater of $5,000 or 2 percent of the total contributions and bequests received by the foundation before the close of the year in which the foundation receives the contribution or bequest from the person in question. Code §5007(d)(2), 686(a)(2).

The members of an individual's family would be determined under section 4946(d) of the Code, which would be amended (for purposes of both the private foundation rules and the proposed excise tax) to include an individual's siblings as members of the individual's family.

Certain organizations are exempted by statute from filing a Form 990. These organizations are (i) churches and certain church-related organizations, and (ii) certain organizations that normally have annual gross receipts of $5,000 or less. In addition, the filing requirement does not apply to the exclusively religious activities of a religious order. The statute provides the Secretary with the authority to relieve other organizations from the filing requirements. This authority has been exercised to exempt from filing, for example, organizations other than private foundations that normally have annual gross receipts of not more than $25,000. For a list of other organizations exempted from the filing requirement by administrative discretion, see section 1.6033-2(g)(1) of the regulations and Revenue Procedures 83-23, 1983-1 C.B. 687, and 86-23, 1986-1 C.B. 564.

End of Text

INTERNAL REVENUE SERVICE ADVANCE REVENUE RULING 94-21, INTEREST RATES FOR QUARTER BEGINNING APRIL 1, 1994, ISSUED MARCH 16, 1994

(TEXT)

(Note: The revenue ruling is scheduled to appear in Internal Revenue Bulletin 1994-21, dated April 4, 1994.)

Part I

Section 6621.—Determination Rate of Interest

26 CFR 301.6621-1: Interest rate.

Rev. Rul. 94-21

Section 6621 of the Internal Revenue Code establishes differential rates for allowance of interest on tax overpayments and assessment of interest on tax underpayments. Under §6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 2 percentage points. Under §6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points. Section 6621(c) of the Code provides that for purposes of interest payable under §6601 on any large corporate underpayment, the underpayment rate under §6621(a)(2) shall be applied by substituting "2 percentage points" for "3 percentage points." See §6621(c) and §301.6621-3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable date. Section 6621(c) and §301.6621-3 are generally effective for periods after December 31, 1990.

Section 6621(b)(1) of the Code provides that the Secretary shall determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) of the Code provides that the federal short-term rate determined under §6621(b)(1) for any month shall apply during the first calendar quarter beginning after such month.

Section 6621(b)(2)(B) of the Code provides that in determining the addition to tax under §6654 for failure to pay income tax or estimated tax for any taxable year, the federal short-term rate which applies during the third month following such taxable year shall also apply during the first 15 days of the fourth month following such taxable year.

Section 6621(b)(3) of the Code provides that the federal short-term rate for any month shall be the federal short-
Annotated Bibliography of Materials
Reviewed through July 1, 1992, by
Subcommittee No. 1 on The Study of Pros
and Cons of Applying the Private-Foundation
Sanctions of Chapter 42 to Public Charities

Prepared by:
Victoria B. Bjorklund, Chair*/
Barry H. Herlihy
Douglas M. Mancino
Jane Gregory Rubin
C. Stephen Saunders

STATUTES AND LEGISLATIVE, ADMINISTRATIVE AND EXECUTIVE MATERIALS


*/ The Chair wishes to thank Judith Ballan and Gregory Welch of Simpson Thacher & Bartlett for their work in compiling this Bibliography.
and John G. Simon. These excerpts generally discuss whether specific sanctions under the 1969 Act bear a rational relationship to the abuses they were designed to prevent, and whether legislation that discriminates against foundations is justified. The excerpts also contain detailed criticisms of specific provisions, as well as suggestions for their improvement.

Graetz, Michael J. Before the Committee on Ways and Means, United States House of Representatives, reprinted in 4 Exempt Organization Tax Rev. 584 (1991). Graetz, Deputy Assistant Secretary (Tax Policy), testified about bills under consideration that would provide intermediate sanctions, such as excise taxes, for failure by tax-exempt hospitals to meet certain standards. Mr. Graetz expressed his belief that imposition of intermediate sanctions should be extended to tax-exempt institutions generally. He criticized the sanction of temporary revocation and favored sanctions modeled on private foundation excise tax provisions.

House Subcomm. on Oversight of the Comm. on Ways and Means, Development of the Law and Continuing Legal Issues in the Tax Treatment of Private Foundations, 98th Cong., 1st Sess. (Comm. Print 1983). This print discusses the legislative history of the private foundation provisions, and then raises and discusses several issues, including whether and
to what extent the distinction for charitable contributions is justified in the context of the limitations imposed by the 1969 Act; whether and to what extent the provisions of the 1969 Act impose appropriate rules for the transactions, investments, and expenditures of private foundations; and whether certain of these limits should be modified in special circumstances or through grants of greater administrative discretion.

Priv. Ltr. Rul. 91-30-002 (Mar. 19, 1991). A tax-exempt hospital sold its hospital facility to members of its Board of Directors. The IRS determined that the hospital did not receive fair market value and the profit of $23.3 million that the Directors realized on resale violated the prohibition against private benefit. The IRS decided that retroactive revocation of exemption was an appropriate sanction.

Senate Comm. on Finance, 89th Cong., 1st Sess., Treasury Department Report on Private Foundations (Comm. Print 1965). This Report discusses the findings of a Treasury Department study of private foundations. The Report highlights the major problems that were revealed by the study, provides detailed examples of abuses, and proposes legislative solutions. A statistical appendix presents estimates of the operation of the charitable contribution provisions of
present law, as well as information on the growth, present size, and operations of foundations.

Staff of Joint Comm. on Taxation, 98th Cong., 1st Sess.,
Description of Income Tax Provisions Relating to Private Foundations (Comm. Print 1983). This pamphlet summarizes the background of the principal private foundation provisions and the 1969 Act, including the reasons for Congress' conclusion that the pre-1969 laws were inadequate or defective. The print also includes a discussion of the distinctions between private foundations and public charities.


Tech. Adv. Mem. 1991 Lexis PRL 2085 (July 9, 1991), reprinted in 4 Exempt Organization Tax Rev. 726 (1991). The United Cancer Council combined educational and fund-raising content in its direct mail campaigns. The IRS concluded that the fund-raising content -- mainly sweepstakes games -- constituted so large a proportion of the mailings that the educational content was insignificant. UCC's exempt status was revoked because (1) it was not carrying on a charitable program commensurate in scope with its financial resources; (2) it operated for the private interest of the sweepstakes promoter rather than the public interest; and (3) it
operated for the substantial nonexempt purpose of operating
sweepstakes games.
BOOKS, PERIODICAL MATERIALS AND OTHER SECONDARY SOURCES


Brier, Bonnie S. "Coping with the Contribution Consideration Problem from the Standpoint of the Charitable Institution and Personal Comments on a Failing System," 3 Exempt Organization Tax Rev. 645 (1990). Brier proposes that an excise tax be imposed on a charity and its foundation managers who knowingly engage in impermissible acts such as those resulting in inurement, electioneering, impermissible levels of private benefit and misrepresentation involving charitable deductions. This penalty would also be extended to other persons who willfully benefit from such acts knowing them to be improper. However, she insists that such a penalty should target only those specific activities that the law expressly seeks to discourage and should not work prophylactically, as the private foundation rules currently do.

(BNA), No. 15, at G-3 (Jan. 23, 1992). The FASB tentatively concluded that nonprofit organizations should be required to report expenses classified by function (e.g., fund-raising, specific programs). The FASB also agreed not to object to the AICPA's issuing an exposure draft explaining that nonprofit organizations should follow GAAP unless there is a specific standard that exempts them.

"FASB Rescinds Statement 32, Concludes Discussions on Endowments, And Begins Project on Hedge Accounting," Tax Notes Today, Feb. 6, 1992 (available on LEXIS, Fedtax library, TNT file). The FASB tentatively decided that, under most conditions, net appreciations on endowments would retain the same restrictions as the endowments themselves.

"FASB Would Ease Rules for Recognizing Contributions to Not-For-Profits," Daily Tax Rep. (BNA), No. 108, at G-10 (June 4, 1992). The FASB tentatively decided that donees will be allowed to recognize contributed services if such services (1) create or enhance other (non-financial) assets; (2) are provided by entities that normally perform those services for compensation; or (3) are substantially the same as services normally provided by the recipient.

tendency of private foundations to engage in controversial, highly-politicized activities and suggests that their tax-exempt status requires them to confine their activities to those that will be "perceived as beneficent by all segments of the national community," such as scientific research and arts patronage. Hart provides specific examples of activities considered abusive.

Hoff, Reka Potgieter. "The Financial Accountability of Churches for Federal Income Tax Purposes: Establishment or Free Exercise?" 5 Exempt Organization Tax Rev. 53 (1992). Professor Hoff examines the rationale for exempting churches from the financial reporting and tax audit provisions applicable to secular nonprofit organizations and concludes that the exemption is not required by the Free Exercise clause and, moreover, the favored treatment churches receive does not serve a valid secular purpose and, therefore, constitutes an impermissible establishment of religion.

Hopkins, Bruce R. "Commentary," 2 Exempt Organizations Tax Rev. 249 (1989). Hopkins concedes that Chapter 42's self-dealing penalties might be profitably extended to public charities, but advocates extending the provisions only to the extent justified by the existence of actual abuses.

emphatically. Starting and Managing a Nonprofit Organization 228-37 (1989). Hopkins compares increased criticism of public...
charities in the late 1980s with the criticism leveled at foundations in the late 1960s. He notes that "sometimes the best defense is a good offense" and suggests that the nonprofit sector should consider supporting the imposition of more numerous sanctions (especially excise taxes imposable on individuals who engage in acts of private inurement) as a means of curbing abuses.

"IRS Has Expanded Use of Closing Agreements, Official Says," Daily Tax Rep. (BNA), No. 86, at H-1 (May 4, 1992). As an alternative to revocation of exemption, the IRS has expanded its use of closing agreements in exempt organization cases. Under a closing agreement, the IRS agrees not to pursue revocation of exemption, if the organization agrees to disengage from and discontinue questionable activities.

"IRS Penalty Task Force Recommendations Address Exempt Organizations," 2 Exempt Organization Tax Rev. 41 (1989). The Task Force concluded that the IRS could more effectively enforce charitable standards upon public charities if excise tax penalties similar to those currently applicable to private foundations were extended to some or all public charities. Because revocation of exemption is so draconian and the only penalty currently available to punish abuses in public charities, the IRS may tend to avoid using the penalty except in the most extreme cases of abuse.
Magat, Richard. "The Big Chill," Foundation News 32 (Nov./Dec. 1989). Magat outlines the social and legislative background of the 1969 restrictions on private foundations. While some of these restrictions could be improved and have been criticized for lack of even-handedness, for cutting more deeply than necessary, and for ignoring negative side effects, they have not had the chilling effect that foundation officials had feared. Congress now has turned its attention to the less-regulated public charities, apparently because it believes that existing restrictions have minimized the potential for abuse in foundations.

McGovern, Jim. "The Nonprofit Health Care Industry: More on 'How Much Is Too Much?"' 2 Exempt Organization Tax Rev. 258 (1989). McGovern predicts that by the end of the century all exempt organizations will be subject to a scheme of excise taxes similar to that of private foundations.

"New IRS Statistics on Nonprofits and Charitable Giving," 92 Tax Notes Today 114 (June 2, 1992). This article summarizes the IRS Statistics of Income Division's paper entitled "Sources of Statistics of Income Data on Nonprofits and Charitable Giving." These statistics show that during the period 1975-90 tax-exempt organizations grew at a much faster rate than the national economy as a whole, and charitable organizations grew at a faster rate than private foundations. In addition, the expenses of charitable
organizations grew at a much slower rate than total receipts.

Simon, John G. "Foundations and Public Controversy: An Affirmative View," in The Future of Foundations 58 (Fritz F. Heimann, ed. 1973). In a reply to an article by Jeffrey Hart, Professor Simon rejects the view that private foundations should engage only in noncontroversial activities and urges them to continue their "public affairs work . . . which, in so many ways, justifies their existence." Nevertheless, he argues that foundations should avoid "needless provocation." One suggestion he offers is that foundations could support controversial causes indirectly by supporting public charities with a specific interest in a public affairs controversy.

---. "The Tax Reform Act of 1969: Looking Backward," Remarks at the Association of the Bar of the City of New York (May 2, 1989). Professor Simon acknowledges that the provisions relating to foundations were "in some respects modestly helpful," but emphasizes that the legislation is flawed, in large part because they were drafted in an atmosphere of popular criticism of foundations. Among the flaws that Simon identifies is the unjustified application of the provisions to foundations alone, when "there was no showing that the vices attributable to foundations could not be found elsewhere in the nonprofit sector." This has had the
unintended effect of diverting resources away from foundations. Although Simon criticizes this aspect of the 1969 Act, he explicitly states that he is not arguing for the regulations to be extended to all public charities.


Streckfus, Paul. "IRS Official Says Tax Law Changes Are Needed to Prevent Future PTLs," 45 Tax Notes 392 (Oct. 23, 1989). Streckfus reports that Robert I. Brauer, Assistant Commissioner (Employee Plans and Exempt Organizations), spoke out in favor of applying a modified version of the Chapter 42 rules to public charities. Citing the PTL case, Brauer expressed his view that the current rules are inadequate. Since revocation of exemption is such a severe penalty and punishes the charity, rather than those responsible for the abuses, the sanction is difficult to impose, even in a case of flagrant abuse, such as PTL.

summary of the Ways and Means Oversight Committee's recommendations for policing lobbying and political activities of tax-exempt organizations. These recommendations include the imposition of a variety of excise taxes patterned on those now applicable to private foundations. Excise taxes would serve as an alternative to revocation of exemption, which may be an unduly harsh sanction for some transgressions.

"Ways and Means Oversight Subcommittee Final Recommendations on Lobbying and Political Activities of Tax-Exempt Groups," Tax Notes, June 15, 1987 (available on LEXIS, Fedtax library, Txnote file). Noting that revocation of exemption may be an ineffective and inappropriate sanction for certain violations of the prohibition against lobbying and political activity, the Subcommittee made several recommendations for the imposition of intermediate sanctions, such as excise taxes, modeled on the special statutory regulations applicable to private foundations.

abuses may undermine public support for foundations and charities.

Yarmolinsky, Adam and Fremont-Smith, Marion R. "Judicial Remedies and Related Topics," 5 Research Papers: Sponsored By The Commission on Private Philanthropy and Public Needs 2697 (1977). Noting that revocation of exemption penalizes the beneficiaries of charity and not the wrong-doers, Yarmolinsky and Fremont-Smith recommend investing federal courts with equity powers similar to those in state courts. Equitable remedies would be made applicable to all 501(c)(3) organizations. Self-dealing rules similar to those applicable to foundations might be extended to public charities, although the authors criticize these rules as being overbroad. The authors propose using a combination of a minimal initial excise tax followed by referral to the courts under equity powers if there is no correction or restitution. The authors also recommend extending § 4944 jeopardy investment prohibitions to public charities.

-- --. "Preserving the Private Voluntary Sector: A Proposal for a Public Advisory Commission on Philanthropy," 5 Research Papers: Sponsored By The Commission on Private Philanthropy and Public Needs 2857 (1977). Yarmolinsky and Fremont-Smith propose the creation of an independent public agency to oversee the activities of philanthropic organizations. Such an agency would not have enforcement
powers, but is necessary to supplement the currently inadequate regulatory efforts by the IRS and states' attorneys general.