

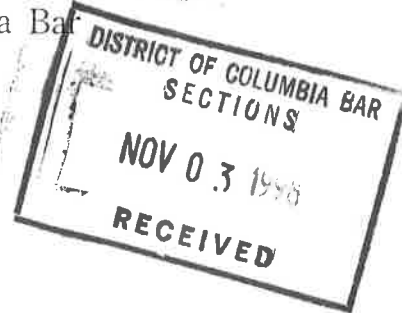
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The District of Columbia Bar

November 2, 1998



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Dear Phyllis:

On behalf of the Section of Taxation of the District of Columbia Bar,¹ we are providing comments on two aspects of the proposed "intermediate sanctions" regulations issued under section 4958 of the Internal Revenue Code, in response to the Notice of Proposed Rulemaking published in the August 4, 1998 Federal Register, 63 Fed. Reg. 41486.

I. Duration of Rebuttable Presumption

The proposed regulations provide a three-part process to establish a rebuttable presumption that compensation is not excessive. Following the procedures to take advantage of the rebuttable presumption, in particular obtaining the necessary salary comparability data, is proving to be quite expensive for nonprofit organizations. As described further below, we recommend that organizations that follow the procedures to establish the rebuttable presumption for compensation paid to their senior executives be allowed to rely on that presumption for a specified number of years, preferably five years, as long as there are no material changes in the employment relationship other than reasonable annual raises.

¹The views expressed herein represent only those of the Section of Taxation of the District of Columbia Bar and not those of the District of Columbia Bar or its Board of Governors. The Section of Taxation is comprised of approximately 1,600 members. These materials were prepared by Cynthia M. Lewin, Barbara Kirschten, Elise Lin, and Brian Menkes of the Exempt Organizations Committee and approved by the Steering Committee of the Section of Taxation (Judith C. Dunn and Catherine E. Livingston having recused themselves).

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A. Provisions of the Proposed Regulations

Based on the applicable legislative history, the regulations establish a rebuttable presumption, under which compensation arrangements (as well as certain other transactions) will be presumed reasonable if:

1. The arrangement was approved by the organization's governing body or a committee of the governing body composed entirely of individuals who do not have a conflict of interest with respect to the arrangement or transaction;
2. The governing body, or committee thereof, obtained and relied upon appropriate data as to comparability prior to making its determination; and
3. The governing body or committee adequately documented the basis for its determination concurrently with making that determination.

Prop. Reg. § 53.4958-6(a).

The regulations bear on the issue of how long the benefit of the reasonable presumption may be relied on in two sections. First, they expressly state:

“The rebuttable presumption applies to all payments made or transactions completed in accordance with a contract provided that the three requirements of the rebuttable presumption were met at the time the contract was agreed upon.”

Prop. Reg. § 53.4958-6(g).

Second, the regulations address the issue of when the reasonableness of a multi-year contract may be determined. Prop. Reg. § 53.4958-4(b)(3) states that a contract for services is judged based on the circumstances existing at the date when the contract was made, unless the reasonableness of the compensation under the contract cannot be determined at the time the contract is made. The regulation provides an example dealing with a multi-year compensation contract, which concludes that where future annual pay increases will equal the increase in the Consumer Price Index, the reasonableness of the contract can be determined based on the circumstances existing at the time the contract is entered into. By comparison, a second example addresses the situation of an employment contract providing for a discretionary bonus with no cap, to be paid as determined by the board of directors. In that case, even though the contract in question only covers one year, the reasonableness cannot be determined at the time the contract is made

because there are no guidelines in the contract regarding the size of the bonus that may be paid. Thus, this provision establishes the concept that where compensation is essentially set in a contract, even a multi-year contract, the reasonableness of the compensation may be determined at the time the contract is entered into. When combined with Prop Reg. § 53.4958-6(g) quoted above, it becomes clear that it should be possible to establish the benefit of the rebuttable presumption for a multi-year contract.²

Unfortunately, these provisions do nothing to deal with a case in which there is no contract, or in which the terms of the contract change each year rather than being set for all years of the contract. Yet these instances are extremely common in the nonprofit sector. Many if not most senior executives below the level of Chief Executive Officer do not have employment contracts. They work in an employment at will capacity, but generally receive annual raises in conjunction with a performance evaluation. And where employment contracts are in place, whether for a CEO or other employee, the contract frequently will simply provide for annual pay increases at the discretion of the board based on performance, or perhaps with a minimum level set at the increase in CPI. Rarely is a maximum annual raise set in such a contract.

The regulations do not provide any special rules for such a situation. Rather, to keep the rebuttable presumption for an executive's compensation in place at all times, as many organizations are being advised to do as a matter of good management practice, the organization must incur the expense and administrative burden of meeting the requirements of the rebuttable presumption each and every year.

² Prop. Reg. § 53.4958-4(b)(3) provides that a written binding contract that is terminable by the tax-exempt organization is treated as a new contract as of each date on which a termination would be effective. If this were the case, then contracts providing for termination on reasonable notice, such as 30 days, could not be covered by the rebuttable presumption for any material length of time. Moreover, employment at will situations, which are terminable at any time, could presumably never be covered by the rebuttable presumption at all. We do not believe that is the intent of the statute, or indeed of the regulation, and recommend that a clarifying change be made, based on the duration of the contract, whether material changes to the contract terms will occur as of the termination date, or similar factors. Our recommendations assume such a change has been made.

B. Recommendation that Rebuttable Presumption
Should Apply for Five Years

In our view, once the rebuttable presumption is properly established with respect to compensation, including obtaining the appropriate compensation surveys and salary data, the organization should be entitled to rely on that for a period of time as long as no significant change occurs in the terms and conditions of employment. We recommend a term of five years, to be applicable as long as the only material change in the employment relationship is a reasonable annual compensation increase.

The five-year time period is consistent with the regulations' two five-year "lookback" periods, one applying the regulations to organizations that were section 501(c)(3) or section 501(c)(4) organizations at any time during the 5-year period preceding a particular transaction, and the other including in the definition of "disqualified person" anyone who qualified as a disqualified person at any time during the five-year period prior to a particular transaction. Prop. Reg. §§ 53.4958-2(a), 53.4958-3(a). Further, from an administrative standpoint, it provides a significant block of time during which the organization can rely on the presumption without having to follow additional procedures, yet limits the potential for inurement by requiring the organization to check its compensation against that of comparable organizations every five years and justify any differences if it wishes to continue to rely on the presumption.

Moreover, the concept of a five-year period finds support in existing IRS precedent, which utilizes a five-year period when judging a contract for reasonableness in a related area. For purposes of tax-exempt bond rules, the IRS has stated that facilities managed by nongovernmental persons under a management contract will not be treated as impermissibly furthering a private business use if at least 50 percent of compensation is fixed and the contract does not exceed five years. Rev. Proc. 97-13, 1997-1 C.B. 632. Longer periods of 10 and 15 years apply when a higher percentage of compensation is fixed. The typical employment situation would meet at least the 50 percent test, as the original salary rather than the amount of salary increases would generally be at least 50 percent of the total over five years, with or without an employment contract.

Revenue Procedure 97-13 also provides for shorter periods for certain kinds of contracts: a maximum of three years where the compensation is based on a per-unit fee, such as a stated dollar amount for each specified medical procedure, and a maximum of two years where the compensation is based on a percentage of revenue or expenses. We would not object if these limited terms were picked up for these specialized types of situations. Even a two- or three- year term would be far better

than no term at all.

In considering this approach, it should be kept in mind that during the proposed five-year period of reliance, only a rebuttable presumption is established. If the Service were to find that the resulting compensation was unreasonable, the presumption can be rebutted.

This approach would be of great benefit for the many organizations that do not use employment contracts for their senior executives. Otherwise, the regulations tend to push organizations into an employment contract environment and away from employment at will. This in turn creates serious personnel management problems if senior executives need to be dismissed for poor performance – a damaging and unintended side effect of the proposed regulations as they stand.

Proposed regulatory language establishing this concept could read as follows:

"If the rebuttable presumption for the compensation arrangement of a disqualified person who is a bona fide employee of the organization has been properly established, the organization may continue to rely on that rebuttable presumption with regard to that disqualified person for a period of five years from the date the compensation is approved, provided that no material element of the employment relationship is changed other than a reasonable annual increase in compensation. If the disqualified person has been replaced, the presumption must be reestablished with regard to the new person in the position.

C. Recommended Clarification of Example

If the above recommendation is not adopted, we suggest that as a less helpful alternative, Example 1 under Prop. Reg. § 53.4958-4 be revised. That example currently provides that the reasonableness of a multi-year contract may be determined at the time the contract is entered into where annual raises are set at the increase in CPI. If that example were restructured to deal with a contract providing that annual raises would be limited to a certain range, rather than specifically set, it would clarify that the exact terms of the contract do not need to be stated as long as reasonable parameters are established. This change would provide additional guidance as to the application of the regulations in their current form. It would not, however, benefit organizations that do not have employment contracts with their executives, and simply rely on employment-at-will and yearly performance increases.

A revised Example 1 could read as follows (*proposed language in italics*):

“Example 1. G is an applicable tax-exempt organization for purposes of section 4958. H is an employee of G and a disqualified person with respect to any transaction involving G that provides economic benefits to H directly or indirectly. H’s multi-year employment contract provides for payment of a salary and provision of specific amounts of health and retirement benefits. The contract provides for an annual increase in H’s salary *in a range from* the percentage increase, if any, over the preceding year in the Consumer Price Index (CPI) *to an amount equal to 10 percent over the CPI increase, as decided by G’s board of directors based on H’s annual performance evaluations.* The CPI for a year is determined using an average of the monthly CPI as determined for each month in that calendar year. The health benefits consist of insurance coverage under a plan that is available to all of G’s employees. The retirement benefits are equal to the maximum amount G is permitted to contribute under the rules applicable to qualified retirement plans. Under these facts, the reasonableness of H’s compensation can be determined based on the circumstances existing at the time G and H enter into the employment contract.”

II. Luxury and Spousal Travel

The Proposed Regulations have delineated three categories of benefits that are disregarded for purposes of determining whether excess benefit has been provided. One such benefit, pursuant to Section 53.4958-4(a)(3)(i) of the Proposed Regulations, applies to “reimbursement for reasonable expenses of attending meetings of [the organization’s] governing body.” “Reasonable expenses” are simply defined as those that do “not include luxury travel or spousal travel.” Beyond that definition, the regulations do not provide clarification about what constitutes “reasonable expenses” or “luxury” or “spousal” travel.

Further guidance on what expenses might violate this standard would be helpful. Reference to or incorporation of an existing standard, such as those applicable to Federal travelers, could provide adequate guidance. 41 C.F.R. §§ 301-10.123, 304-1.3(b). Generally, under Federal travel rules, upgraded accommodations, including those for travel by common carrier and for lodging, may be paid if:

- no other class of accommodation is reasonably available,
- upgrades are necessary to accommodate a traveler’s disability or illness,
- the cost of common carrier upgrades is offset by a reduction in lodging

- costs or loss of productive work time, or
- the scheduled flight time is in excess of 14 hours.

Similarly, Federal travel regulations allow the spouses of government officials to accompany them to off-site meetings (at the expense of a non-governmental sponsor) if:

- the spouse's presence would help the government official carry out his/her duties more effectively,
- the trip includes an award ceremony which honors the government employee, or
- the spouse has substantive knowledge or experience which would enhance the purpose of the meeting.

Including a similar rule in the intermediate sanctions regulations would clarify that spousal travel paid for by a third party, such as an organization bestowing an award or a donor, will not be recharacterized as compensation to the nonprofit employee.

Many of the "exceptions" that permit luxury or spousal travel for government employees could be used to justify upgraded travel for employees of nonprofit organizations. In our view, the final regulations would be significantly strengthened by a clear reference to the permissibility of upgraded travel in situations that, at minimum, parallel the Federal government's standards.

Regulatory language at Prop. Reg. § 53.4958-4(a)(3) could read as follows (*changes in italics*):

"(3) Certain economic benefits disregarded for purposes of section 4958. The following economic benefits are disregarded for purposes of section 4958:

(i) Reimbursements for reasonable expenses of attending meetings of governing body. Paying reasonable expenses for members of the governing body of an applicable tax-exempt organization to attend meetings of the governing body of the organization will be disregarded for purposes of section 4958. For purposes of the preceding sentence, reasonable expenses do not include luxury travel or spousal travel, *except that luxury travel and spousal travel meeting the standards of the Federal travel regulations (41 C.F.R. §§ 301-10.123 and 304-1.3(b)) shall be presumed to be reasonable. No inference that travel not meeting the standards of the Federal travel regulations is therefore an excess benefit transaction shall be drawn.*"

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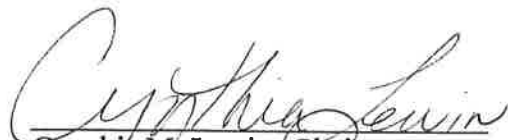
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We urge the Service to adopt a provision enabling organizations to benefit from the rebuttable presumption for several years after establishing it once, as long as no material changes in the employment relationship occur. The nonprofit resources that will be saved thereby can be put to much better use, in carrying out the many and varied missions of the nonprofit sector. We further urge clarification in the definition of "luxury and spousal travel" by reference to existing Federal standards.

Please contact us if you would like more information about these comments or if we can be of assistance in any other way. Thank you for your consideration.

Sincerely,



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