



HEALTH CARE

IRS ISSUES PROPOSED REGULATIONS ON THE RELATIONSHIP BETWEEN PARTICIPATION IN EXCESS BENEFIT/PRIVATE INUREMENT TRANSACTIONS AND REVOCATION OF TAX-EXEMPT STATUS

On September 8, 2005, the IRS released a set of Proposed Regulations that set forth the standards the IRS proposes to use to determine whether to revoke the § 501(c)(3) status of an organization that has engaged in a transaction that constitutes both (i) traditional private inurement under § 501(c)(3) of the Tax Code and (ii) an excess benefit transaction under the intermediate sanctions rules of § 4958 of the Tax Code. The private inurement rules and the intermediate sanctions rules will always overlap, and, as a result, these Proposed Regulations will apply to all transactions where an insider directly or indirectly receives a non-fair market value economic benefit (either goods or services) from a § 501(c)(3) organization.

Under these Proposed Regulations, there is a direct connection between responsible corporate governance and compliance practices and continued tax exemption. Organizations that attempt in good faith to follow good corporate governance and compliance practices both before and after a private inurement problem occurs (even a big private inurement prob-

lem) will survive with their tax-exempt status intact. Those organizations that do not follow good corporate governance and compliance practices will lose their tax-exempt status; in addition, the insiders involved in the problematic transactions will not only be subject to intermediate sanctions excise tax penalties but may also lose their jobs.

In this regard, the Proposed Regulations are the first attempt to put into place, in a formal, precedential fashion, the standard recently articulated by IRS Commissioner Everson in his May 26, 2005, testimony before the House Ways and Means Committee in its consideration of the proper standards for tax exemption for health care organizations. In his testimony, Commissioner Everson noted that the principal criterion the IRS looks at “to differentiate the tax-exempt hospital from a for profit operation” is whether the hospital has an “independent board exercising its fiduciary duty to operate for the benefit of the community.”

In making the determination as to whether or not to seek revocation of tax-exempt status, the Proposed Regulations say that the IRS will consider all relevant facts and circumstances, including, but not limited to, the following:

1. The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred.
2. The size and scope of the excess benefit transaction or transactions (collectively, if more than one) in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes.
3. Whether the organization has been involved in repeated excess benefit transactions.
4. Whether the organization has implemented safeguards that are reasonably calculated to prevent future violations.
5. Whether the excess benefit transaction has been "corrected" (that is, whether the excess benefit has been repaid, plus interest), or the organization has made good faith efforts to seek correction from the insiders who benefited from the excess benefit transaction.

All of the foregoing factors will be considered in combination with each other, and depending on the particular situation, the IRS may assign greater or lesser weight to some factors than to others. Factors 4 and 5 will weigh more strongly in favor of continuing to recognize exemption where the organization discovers the excess benefit transaction or transactions and takes action before the IRS discovers the excess benefit transaction or transactions. Further, with respect to Factor 3, correction after the excess benefit transaction or transactions are discovered by the IRS is never, standing alone, a sufficient basis for continuing to recognize exemption.

The Proposed Regulations make it clear that *de minimis* amounts of private inurement will not result in loss of tax-exempt status if the inurement was inadvertent and if the organization acted reasonably before and after the problem is discovered. This marks a dramatic, and positive, change from the old, draconian notion that the "no part" of the "net earnings" language of § 501(c)(3) meant that any amount of private inurement, however small or unintended, would lead to loss of tax-exempt status. The Proposed Regulations get rid of this old, largely unworkable, idea and replace it with a more commonsense, practical approach.

The Proposed Regulations also make it clear that substantial private inurement will not result in revocation of tax-exempt status if, after discovery of the problem, and before the IRS raises the issue on audit, the organization takes whatever steps it can (i) to correct its prior sins and (ii) to put in place policies and procedures reasonably designed to prevent a reoccurrence of the problem. Those steps include, where appropriate:

1. Removing the fiduciaries (directors, officers, and senior management employees) who allowed the private inurement to occur.
2. Appointing new, disinterested fiduciaries who will act mindfully of their duties to perform due diligence and to avoid conflicts of interest.
3. Taking aggressive action to recover any excess benefits from insiders.
4. Taking reasonable steps to put in place policies and procedures designed to prevent problems in the future.

In short, there is an emphasis throughout the Proposed Regulations on accountability. This nexus between accountability and tax-exemption will make it more likely that, in order to maintain tax-exempt status, boards will have to act to remove top executives who are responsible for bad conduct, either by participating in it directly or by sloppy supervision of others who get in trouble. It also makes it more likely that the IRS will require board members who did not act to supervise management properly to step aside in favor of board members who will perform due diligence and who will properly supervise management.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

James R. King

1.614.281.3928

jrking@jonesday.com

David S. Boyce

1.213.243.2403

dsboyce@jonesday.com