

## Intermediate Sanctions: A Trap for the Unwary Insider

Two years ago, the Internal Revenue Service (IRS) issued final regulations that clarify the imposition of a type of sanction commonly known as an “intermediate sanction”—on excess benefit transactions entered into between tax-exempt organizations and the individuals who have substantial influence over them. Because of the broad application of these rules and the substantial penalties involved, including taxes on directors, it is imperative that the directors and administrators of nonprofit organizations understand the elements and operation of the law. Given the heightened focus on corporate activities by federal and state regulators, we thought an in-depth reminder may be of help at this time.

### a. What is an Excess Benefit Transaction?

An excess benefit transaction is any transaction that provides an economic benefit to a tax-exempt organization’s insiders, referred to as “disqualified persons,” where the value of the benefit exceeds the consideration received in return. In determining whether an excess benefit transaction has occurred, every transaction that benefits a disqualified person is taken into account, regardless of whether the benefit is direct or indirect and whether it is provided directly by the exempt organization or through an intermediary or controlled entity. For this purpose, control constitutes ownership of more than 50 percent interest in an organization.

Generally, contracts and business dealings that appear to extend favorable terms to insiders invite greater IRS scrutiny. An excess benefit transaction typically occurs when the amount paid to a disqualified person

exceeds the value received by the exempt organization. That can be in the context of a purchase or sale of property, or the payment of compensation. The regulations define the term “fair market value” as a price that is paid by a willing buyer to a willing seller, neither being under compulsion to enter into the transaction, and both having knowledge of all the relevant facts.

Fair market value ordinarily becomes an issue when a sale or purchase of property is involved. Since valuation is more of an art than a science, how property is appraised could make the difference between a transaction that results in the imposition of sanctions and one that does not. For instance, in a recent court case, the valuation opinion that the taxpayers relied upon was rejected by the Tax Court and the IRS in favor of a valuation methodology that produced significantly higher value. The result was the imposition of substantial intermediate sanctions upon the taxpayers. *Caracci v. Commissioner*, 118 T.C. 379 (2002). In that case, the Caracci family, who founded and operated three tax-exempt entities, desired to convert the entities to for-profit corporations. In the process of doing so, the family secured appraisal services from an accounting firm. That firm rendered the opinion that the liabilities of the three tax-exempt entities exceeded the fair market values of their assets.

Based on this information, the family transferred the assets of the three exempt entities to three newly organized for-profit corporations in exchange for assumption of the exempt entities’ liabilities. The IRS

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determined that the fair market value of the transferred assets exceeded the assumed liabilities by approximately \$20 million, and assessed deficiencies and intermediate sanctions totaling over \$256 million. Focusing on certain attributes of the three exempt entities not taken into account by the accounting firm, the Tax Court arrived at a net value of \$18 million for the assets of the exempt entities, and upheld the imposition of sanctions. While *Caracci* involved a family-controlled business, the same principles would apply if, for example, a tax-exempt hospital enters into a contract to purchase the practice of a physician who is also a hospital director.

Reasonable compensation tends to be an area that is prone to excess benefit transactions. In general, compensation arrangements between an exempt organization and its officers, directors, and key suppliers are suspect. For tax purposes, reasonable compensation is no more than the amount that would ordinarily be paid for like services by like enterprises under like circumstances. All forms of monetary and non-monetary compensation, including non-cash deferred compensation at the time of vesting, must be taken into account in determining whether an excess benefit transaction has occurred. The types of benefits that are taken into account include medical, dental, and life insurance, severance pay, disability benefits, certain fringe benefits, and the economic benefit of a below market loan.

The regulations provide a limited “safe-harbor” rule in respect of compensation. Under the safe harbor, compensation is presumed to be reasonable if it is approved in advance, by an authorized body that is free from conflict of interest, is based on appropriate comparability data, and if there is concurrent and sufficient documentation indicating the basis for the determination. A member of an authorized body has no conflict of interest only if the member: (a) is not participating in the subject compensation arrangement or is not a family member of such a person; (b) is not in respect of employment or pay, subject to the direction, control or approval of the disqualified person; (c) has no material financial interest that is affected by the compensation arrangement; or (d) does not approve the compensation arrangement on a quid pro quo basis. A sample conflict of interest policy can be found on the website of the Office of Minnesota Attorney General. If the safe harbor is met, the burden of proof shifts from the tax-exempt organization to show that the compensation was reasonable, to the IRS to show that it was unreasonably high.

### **b. What are the Sanctions?**

An excise tax of 25% of the excess benefit is imposed on a disqualified person who participates in an excess benefit transaction. If the transaction is not corrected within a prescribed period, then a tax of 200% of the excess benefit is added on to the 25%. The disqualified person can avoid the imposition of the additional penalty if the excess benefit transaction is corrected

during the taxable period. The correction period begins on the date the transaction occurs and ends on the earlier of the date the notice of deficiency is mailed or the 25% excise tax was assessed. The regulations permit abatement of the 200% tax if the disqualified person corrects the excess benefit transaction within 90 days of assessment.

A disqualified person can correct an excess benefit transaction by undoing the transaction to the extent possible, and taking additional steps necessary to restore the organization’s financial position to where it would have been had the transaction not occurred. This includes returning to the organization the sum of the excess benefit, plus interest per an IRS rate. The payment must be in cash or cash equivalents, and payments by promissory notes are not taken into account.

If the excess benefit transaction involves specific property, the disqualified person may make a correction by returning the property, provided that the organization agrees to that method of repayment. In that situation, the disqualified person is treated as making a payment equal to the lesser of the fair market value of the property determined on the date of return or on the date the excess benefit transaction occurred. If this method of correction results in less than the correction amount described above, i.e., excess benefit plus interest, the disqualified person must make an additional cash payment equal to the difference.

The Minnesota Attorney General likely will treat an excess benefit transaction as an improper diversion of corporate assets, and require correction even if that has not been done in time to avoid the 200% tax. And it is likely that indemnification by the organization would be prohibited, or simply compound the excess benefit subject to tax. So, the penalties to the disqualified person can be draconian.

An excise tax is also imposed on organization managers (directors or trustees) who participate in an excess benefit transaction knowingly, willfully and without reasonable cause. The tax is equal to 10 percent of the excess benefit, not to exceed \$10,000. Note that the \$10,000 is an aggregate, and all organization managers participating in the transaction are jointly and severally liable. Organization managers who receive excess benefits may be subject to all of the three excise taxes discussed above.

### **c. Which Organizations Are Affected?**

With certain exceptions, the intermediate sanctions apply to all Sections 501(c)(3) and 501(c)(4) organizations. Private foundations, governmental entities and their affiliates, and foreign organizations that receive substantially all of their support from sources outside the United States are generally exempt from intermediate sanctions. Note that private foundations are subject to a self-dealing excise tax under another section of the Internal Revenue Code.

#### d. Who Is Subject to Intermediate Sanctions?

The intermediate sanctions are directed at those persons who hold certain powers, responsibilities, or interests within tax-exempt organizations, which the IRS lumps into two groups: “disqualified persons” and “organization managers.” A disqualified person is any person who can exercise substantial influence over the affairs of a tax-exempt organization during the five-year period ending on the date of the excess benefit transaction. Disqualified persons include voting members of the governing body of an exempt organization, its officers (the CEO and CFO are specifically disqualified persons), family members of persons with substantial influence, and 35 percent controlled entities.

The regulations describe categories of persons who are deemed not to have substantial influence. For example, employees that are neither substantial contributors nor highly compensated are deemed not to have substantial influence. The IRS leaves itself “wobble room” by providing for a facts-and-circumstances test to determine whether an individual or organization is a disqualified person.

Under the regulations, the following are presumptively disqualified persons: (1) founders; (2) substantial contributors; (3) persons with controlling interests, measured by vote or value; (4) persons whose compensation is based on revenues derived from activities that they control; (5) persons who exercise control over capital expenditures, operating budgets, or compensation of employees; (6) persons who manage departments that significantly contribute to the entire organization; and (7) a non-stock organization controlled, directly or indirectly, by one or more disqualified persons.

The regulations also note persons presumed not to have substantial influence: (1) persons who have taken a bona fide vow of poverty as employees or agents of a religious organization; (2) contractors whose sole relationship to the organization is to provide professional advice in

exchange for customary fees; (3) persons whose direct supervisors are not disqualified persons; (4) persons who do not participate in any management decisions concerning the entire or major segments of the organization; and (5) a donor who is offered preferential treatment when compared to other donors making comparable contributions.

With respect to organization managers, penalties are imposed on those who knowingly participate in excess benefit transactions and fail to demonstrate that there was reasonable cause for their actions. An organization manager is any officer, director, or trustee of an applicable tax-exempt organization, or any individual having powers or responsibilities similar to officers, directors, or trustees of the organization, regardless of title. An organization manager is not considered to have participated in an excess benefit transaction where the manager has opposed the transaction in a manner consistent with the fulfillment of the manager’s responsibilities to the organization. So directors or trustees who vote in opposition to a transaction that they fear is an excess benefit transaction should ensure that their opposition is recorded in the minutes. Contrariwise, an organization manager will be considered to have participated in an excess benefit transaction simply due to silence or inaction, where the manager is under a duty to speak or act.

Although the intermediate sanctions are a less drastic means of combating excess benefit transactions, the Internal Revenue Code has not eliminated or modified the standards for revocation of tax-exempt status. Consequently, the IRS has the discretion to apply either or both of those measures in addressing private inurement issues.



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# Fee Splitting: When Is It Dangerous To Pay Your Rent?

The Minnesota Court of Appeals recently determined that payment of rent by a group of dentists would violate the state dental fee-splitting laws. However, the Court's decision doesn't provide medical and dental professionals a legal reason to welch on their lease obligations. According to the court, "rent" obligations that violate state law involve payments to landlords for certain services above and beyond simply providing clinic space.

The case, *Alpha Real Estate of Rochester v. Delta Dental Plan of Minnesota et al*, arose out of a relationship between a group of dentists in the Rochester, Minnesota area and Delta Dental Plan of Minnesota. Delta Dental is an insurance company that provides dental insurance and administration services for dental insurance products.

Testimony at trial in Hennepin County District Court established that Delta Dental did not have enough dentists participating in its networks in the Rochester, Minnesota area in 1995 to service some of Delta's large corporate clients, including IBM. Delta Dental approached a Faribault dentist and urged him to start a practice in Rochester in part to service Delta Dental's insureds and customers. As part of the early negotiations between Delta and the dentist, the parties considered a possible 50/50 ownership of the new clinic by Delta Dental and the dentist and his partners. However, concerns were raised that the 50/50 ownership model would violate laws regulating who can and cannot own Minnesota professional corporations. The parties revised their proposal so that Delta would instead receive 5% of the new clinic's gross receipts under a model not involving outright joint ownership.

In order to accomplish this, the parties agreed that Delta Dental would finance construction of a new dental clinic in Rochester, and lease it to the group of dentists. However, testimony at trial showed that both Delta Dental and Faribault dentist did not want their financial relationship made known to others in the community. To this end, Delta Dental created a separate subsidiary corporation, Sui Generis, to act as the landlord for the new dental clinic. Delta Dental attorneys wrote a lease agreement between Sui Generis and Alpha Real Estate, the corporation established by the dentists to act as the tenant. In documents filed with the state creating Sui Generis, Delta attorneys carefully avoided any reference to Delta. Delta also established a post office box mailing address for Sui Generis separate from that of Delta Dental. Witnesses testified that Delta took both of these actions in order to keep the relationship between Delta and Sui Generis out of the public eye. Finally, with Sui Generis successfully created, Delta's attorneys prepared a

lengthy lease agreement spelling out the respective responsibilities of the landlord (Sui Generis) and the tenant (Alpha Real Estate), including the requirement that the Alpha pay monthly rent to Sui Generis.

Simultaneously, Delta Dental attorneys also drafted a confidential agreement between Delta Dental and Alpha Real Estate which set forth the new relationship between Delta and the dentists. This secret agreement contained a requirement that each year the gross production of the new clinic exceeded \$1 million, the dentists must pay 5% of the adjusted cash receipts over to Delta Dental. Although the lease agreement specified how much "rent" Alpha Real Estate was to pay Sui Generis on a monthly basis, the secret agreement characterized the 5% payment obligation as "additional rent".

The confidential agreement also contained a section explaining the purpose of the 5% "additional rent" payment. According to the agreement, the purpose of the 5% "additional rent" payment was twofold; as (1) reimbursement for the risk assumed by Delta under the agreement, and (2) as a partial contribution to defraying Delta's cost of marketing products in the Rochester area so as to provide a satisfactory volume of patients for the Rochester, Minnesota clinic.

Delta Dental constructed the new clinic and began leasing it to the dentists (as "Sui") in 1996. The dentists decided in 1999 that they wanted to purchase the clinic, and tried to exercise their option to purchase granted them in the lease agreement. Delta Dental refused to let the dentists purchase the clinic, arguing that the clinic exceeded \$1 million gross revenues in 1998 and 1999, and the dentists hadn't paid the 5% "additional rent" due for those two years. The dentists, after consultation with their Felhaber lawyers, argued that the 5% additional rent" clause violated state and federal law, and refused to pay it. The dispute headed to court.

One of the dentists' arguments was that the "5% clause" violated the Minnesota dental fee-splitting law. State law makes it unlawful for a dentist to divide fees with or promise to pay a part of the dentist's fee to, anyone who calls the dentist in consultation or who sends patients to the dentist for treatment. A corresponding regulation clarifies that no person may directly or indirectly offer, give, receive, or agree to receive any fee or other consideration to or from a third party for referral of a patient in connection with the performance of professional dental services.

The Court of Appeals determined that part of the purpose of the 5% "additional rent" payment was to reimburse Delta Dental for its efforts to market on behalf of the Rochester clinic. The Court noted language in the secret agreement that part of the purpose of the

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5% "additional rent" requirement was to defray Delta's costs of marketing so as to provide a "satisfactory volume" of patients to the new clinic. The Court also reviewed evidence presented at trial that Delta had moved patients from two other dental clinics to the new Rochester clinic, offered to send a marketing letter to IBM, included the Rochester clinic in an IBM marketing fair, and had contacted the Mayo Clinic about having the Rochester clinic provide general dentistry services to the Mayo's employees. The Court found that these marketing efforts constitute the types of efforts to "send patients to the dentist for treatment" that are prohibited by the broad fee-splitting statute. Accordingly, the Court determined that the 5% "additional rent" requirement was unlawful, and Delta Dental could not require the dentists to pay it.

The implications of this decision for Minnesota health care professionals are several. Other health care professionals, including physicians, are prohibited from engaging in fee-splitting much the same way dentists are. For example, Minnesota law prohibits physicians from "paying, offering to pay, receiving, or agreeing to receive, a commission, rebate, or remuneration, directly or indirectly, primarily for the referral of patients or the prescription of drugs or devices". This broad

language would seem to prohibit the types of payments for marketing services involved in the Delta Dental case. The author is aware of various types of practice management agreements utilized by Minnesota physicians, dentists and other health care professionals. To the extent that these agreements call for payment for services rendered based on a percentage of patient revenues, these types of agreements may violate state law as well.

The ramifications of violating state fee-splitting laws can be serious for the licensed professional. Typically, a violation of fee-splitting laws can subject licensed professionals to disciplinary action by state licensing boards. Disciplinary action taken against a physician's or dentist's license can result in suspension or revocation of a license to practice.



So, do you pay the rent or not? Yes – if in fact it's rent, the whole rent, and nothing but the rent.

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## The St. David's Case: Joint Ventures Between Tax Exempt and For Profit Entities

The Fifth Circuit Court of Appeals issued an opinion in November of 2003 which explores the circumstances under which tax-exempt entities could enter into joint ventures with for-profit entities without jeopardizing their exempt status. In that case, *St. David's Health Care System v. United States*, the Court stated that a hospital would not qualify for a Section 501(c)(3) exempt status, even if it performs charitable activities, if its activities substantially further the profit-seeking activities of its for-profit partner. The Court of Appeals sent the case back to the district court. Final disposition is not yet known. However, if your tax-exempt organization has, or is contemplating, a joint venture with a for-profit entity, the *St. David's* opinion of the Fifth Circuit Court of Appeals could be instructive.

In *St. David's*, the IRS argued that the hospital failed the operational test, which requires an exempt entity to engage primarily in activities that accomplish its exempt purpose, when it partnered with a for-profit entity and its primary purpose ceased being charitable. Whether the exempt entity

retained control over the venture was a key element in the positions taken by the court of appeals and the IRS. The court examined the structure and management of the venture to determine which individuals or entities had control.

IRS officials point out that two factors must be considered when tax-exempt entities enter into joint ventures with for-profit entities: whether the joint venture furthers the tax-exempt entity's exempt purpose and whether the venture is arranged so that the exempt organization retains control. A non-profit entity can demonstrate control by showing the following: (1) the founding documents of the partnership expressly state that it has a charitable purpose and that the charitable purpose will take priority over all other concerns; (2) the partnership agreement gives the exempt entity a majority vote in the partnership's board of directors; and (3) the partnership is managed by an independent company, i.e., not affiliated with the for-profit entity.



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# Welcome Our New Attorneys

Felhaber, Larson, Fenlon & Vogt, P.A. is pleased to announce that **Wendy M. Brekken**, **Donald G. Heeman**, and **Pomy Ketema** have joined our firm. Please join us in welcoming them to Felhaber. To read their individual biographies, please log on to [www.felhaber.com](http://www.felhaber.com).



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# HEALTH LAW MONITOR

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The *Health Law Monitor* is a report on legal developments. It is not intended to be legal advice and should not be relied on without consulting counsel.

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