tax relief

decoding the code

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Special Not-For-Profit Issue

There are well over one million organizations that are recognized under federal law as being exempt from income tax. These organizations control over $1 trillion in assets and generate over $1 trillion in revenue annually. It should come as no surprise, therefore, that these organizations have been the subject of increased scrutiny by the IRS over the last several years. From the perspective of the IRS, the last twelve months have been an especially active period. This issue of Tax Relief is devoted to describing some of these recent developments and their impact on tax-exempt organizations. ◆

Joint Ventures

By Louis Vlahos

In 2000, the IRS revoked the tax-exempt status of St. David's Health Care System, Inc. retroactively to 1996, the year in which the hospital entered into a limited partnership with a for-profit health care company, HCA Inc. Earlier this year, however, a federal district court overturned the IRS's ruling.

The partnership in question had two general partners and two limited partners. The general partners were St. David's and a wholly-owned, for-profit subsidiary of HCA. Each general partner held a ten percent interest in the partnership, but the HCA subsidiary acted as the managing partner. The two limited partners included St. David's and a second wholly-owned HCA subsidiary. St. David's aggregate ownership interest in the partnership, as a limited and general partner, was forty-six percent, and the HCA subsidiaries held the remaining fifty-four percent ownership interest. Among other things, the partnership agreement provided for a governing board, half the members of which would be appointed by St. David's and the other half by HCA.

The IRS ruled that St. David's "participation in the partnership does not permit it to act exclusively in furtherance of its charitable purposes and allows for greater than incidental benefits to HCA and its for-profit subsidiaries." The IRS ruling appears to have been based on the fact that St. David's ownership interest in the partnership did not, on its face, represent a "controlling" interest.

It has been the long-standing position of the IRS that a tax-exempt organization may form and participate in a partnership without jeopardizing its favored tax status, provided its participation furthers a charitable purpose and the partnership arrangement permits the tax-exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of any for-profit partners. Thus, in its most recent published ruling on the subject, the IRS stated that where an exempt organization controls the governing board of the partnership–i.e., appoints a majority of the board–it can ensure that the assets and activities of the partnership are used primarily to further exempt purposes and that the benefit to "private" (i.e., for-profit) parties will be incidental to the accomplishment of charitable purposes.

However, if a for-profit entity is allowed to control or use the tax-exempt organization's

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This issue of Tax Relief inaugurates the appearance of a new column, "Taking Account," which will feature articles by respected members of the Long Island accounting community.

Taxation of Corporate Sponsorship Payments

By Timothy W. Mulcahy, CPA and Jason Chin, CPA

Generally, tax-exempt organizations are not subject to federal income tax on income earned from activities that are related to the organization's exempt function. Income from activities that are unrelated to the organization's exempt purpose, however, may be subject to the unrelated business income tax ("UBIT"). Gross income from an exempt organization will be subject to UBIT if: (1) the income is derived from a trade or business; (2) the business is regularly carried on; and (3) the business activity is not substantially related to the organization's exempt function.

In 1997, Congress added a "safe harbor" provision to the UBIT rules which provides that an exempt organization's receipt of "qualified sponsorship payments" does not constitute receipt of income subject to UBIT. Earlier this year, the IRS issued final regulations (the "Regulations") implementing this change in law.

Qualified sponsorship payment. The Regulations define a qualified sponsorship payment as any payment made by a person engaged in a trade or business to an exempt organization, provided that there is no arrangement or expectation that the person making the payment will receive a "substantial return benefit." The "payment" may be made in the form of money, property or the performance of services.

A sponsorship payment that is not a qualified sponsorship payment will not automatically be subject to UBIT. In a situation where a sponsorship payment fails to satisfy the safe harbor, the determination of whether such a payment will be taxable to the exempt organization as unrelated business income is made under existing rules and principles.

Substantial return benefit. The Regulations define a "substantial return benefit" as any benefit other than (1) the use or acknowledgment of the name or logo of the sponsor's trade or business in connection with the activities of the exempt organization or (2) certain goods or services that have an insubstantial value. The display and distribution of a sponsor's products at an exempt organization's event is not considered a substantial return benefit. Exclusive sponsorship arrangements, value-neutral descriptions of the sponsor's product-line or services and listings of the sponsor's locations, telephone numbers or Internet address also are not considered substantial return benefits.

Disregard benefits. Benefits provided to a sponsor are disregarded in determining whether the sponsor has received a substantial return benefit if the aggregate fair market value of all the benefits provided to the sponsor in connection with the sponsorship payment during the tax exempt organization's taxable year is not greater than 2% of the amount of the sponsorship payment.

If the benefits received by the corporate sponsor exceed 2% of the amount of the payment, then only the portion of the payment that exceeds the substantial return benefit is a qualified sponsorship payment; the balance is subject to the general rules regarding UBIT. The burden is placed on the exempt organization to show that the amount of a sponsorship payment exceeds the fair market value of the substantial return benefit.

The regulations provide the following example to illustrate how the 2% limit is applied: An art museum organizes an exhibition and receives a large payment from a corporation to help fund the exhibition. The museum recognizes the corporation's support by using the corporation's name and logo on banners, posters, brochures and public service announcements. The museum also hosts a dinner for the corporation's executives. The fair market value of the dinner exceeds 2% of the total sponsorship payment. The museum's use of the corporate name and logo in connection with the exhibition constitutes acknowledgement of the sponsorship, and, therefore, is not a substantial return benefit. However, because the fair market value of the dinner exceeds 2% of the total sponsorship payment, the dinner is a substantial return benefit. Only that portion of the payment, if any, that the museum can demonstrate exceeds the fair market value of the dinner will be treated as a qualified sponsorship payment.

Advertising. Advertising provided by an exempt organization the value of which exceeds the 2% threshold will be treated as a substantial return benefit. Any promotion of a sponsor's products or services is considered advertising and not merely "use or acknowledgment."

Exclusive Provider. An exclusive provider arrangement that limits the sale, distribution, availability, or use of competing products, services, or facilities in connection with an exempt organization's activity generally results in a substantial return benefit. For example, if a soft drink manufacturer enters into a contract with a college to become the exclusive provider of all soft drinks sales on campus, this would be considered a substantial return benefit.

Internet. An exempt organization that provides a hyperlink on its website to a sponsor's website but does not promote the sponsor or advertise the sponsor's merchandise is not considered to be providing a substantial return benefit to the sponsor. However, a statement on the sponsor's website that the exempt organization endorses the sponsor's product is advertising and is considered a substantial return benefit.

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Joint Ventures [cont'd]

by Louis Vlahos

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activities or assets for the benefit of the for-profit entity, and that benefit is not incidental to the accomplishment of exempt purposes, the tax-exempt organization will fail to be operated exclusively for charitable purposes and, consequently, will lose its tax-exempt status. Thus, the IRS also has held that where the tax-exempt partner shares control equally with the for-profit partner, then the tax-exempt partner will not be engaging primarily in activities that further an exempt purpose, since it cannot initiate charitable programs without the for-profit's consent. (See also the Tax Court's recent decision in Redlands Surgical Services v. Comr., where the IRS maintained, and the Tax Court agreed, that the not-for-profit organization was effectively a minority owner and had "ceded effective control over the operations of the partnership" to a for-profit entity, which indicated that the organization was operated for a substantial non-exempt purpose and conferred an impermissible benefit on its for-profit partner.)

Although its published ruling emphasized the importance of majority control, the IRS evinces a more flexible approach to examining joint ventures involving tax-exempt organizations in its latest instructional program for IRS agents, in which it states that the determination as to whether a joint venture furthers the charitable purpose of the tax-exempt partner and permits it to act exclusively in furtherance of its exempt purposes is based on all of the facts and circumstances.

In particular, agents are instructed to consider whether or not the exempt entity has been able to maintain sufficient control over its activities for it to be able to establish that it will be operated exclusively for exempt purposes. According to the instructional program, "this is not a narrow look at control" and "more than ownership percentages and board votes are taken into consideration." While the instructional program enumerates a number of factors to be considered, it does not indicate what minimum standards, in the absence of majority control, would have to be met in order for the joint venture to pass muster in the eyes of the IRS.

Notwithstanding this seemingly more flexible approach, the IRS argued, with respect to St. David's, that because the for-profit HCA entity appointed one-half of the governing board of the partnership, it could veto any actions sought by St. David's appointees; in other words, the lack of majority control was fatal. The district court, however, responded that the partnership agreement contained "exceptional protections against running the hospital in pursuit of private interests."

Specifically, the agreement required that all hospitals owned by the partnership be operated in accordance with the so-called "community benefits standard." In addition, if a hospital were to fail to meet this standard, St. David's had the unilateral right to dissolve the partnership. Moreover, the position of chairman of the partnership's governing board was reserved for a member appointed by St. David's; therefore, St. David's exercised control over the partnership's agenda. The tax-exempt organization also had the right to unilaterally remove the chief executive officer of the partnership, thereby giving it a disproportionate impact on day-to-day operations. These provisions, according to the court, clearly protected St. David's not-for-profit, charitable pursuits.

The court rejected the government's focus on majority control, emphasizing that the law is more concerned with the fact of "control," regardless of whether that control springs from a majority position or from a particular corporate structure or other arrangement. In light of the structural and operational protections described above, the district court held that St. David's had substantially more control over the partnership than did the for-profit partner, despite the facial 50/50 split in voting rights on the board.

The St. David's decision represents a significant victory for tax-exempt organizations seeking to participate in joint ventures with for-profit partners. In particular, it calls into question the IRS's position that the dominant factor in determining the effect on a tax-exempt organization's status of participating in a joint venture is its control of a majority of the joint venture's governing board, at least when other protections are established to ensure the organization's continued charitable operations. In addition, it sheds some light on the kinds of structural or contractual arrangements that may be utilized to preserve an exempt organization's charitable mission and tax status in the context of a joint venture.

It remains to be seen, however, what the life span of the decision will be: the IRS announced recently that it plans to appeal the district court's holding. Stay tuned. ◆

Deferred Compensation

by Louis Vlahos

The Code describes several forms of deferred compensation for employees of tax-exempt organizations. The most flexible of these deferred compensation arrangements is found in Section 457(f).

In general, Section 457(f) provides that, in the case of an agreement for the deferral of compensation, the deferred compensation is includible in the gross income of the employee when deferred or, if later, when the employee's right to the compensation ceases to be subject to a substantial risk of forfeiture. Whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists where an employee's right to compensation is conditioned upon the future performance of substantial services. The IRS has indicated that a substantial risk of forfeiture exists if the employee is required to perform at least two years of service after he becomes a participant in the deferred compensation plan in order for his rights to vest in the deferred compensation.

These deferral rules do not apply, however, with respect to that portion of any deferred compensation plan which consists of a transfer of property "described" in Section 83 of the Code (relating to transfers of property in connection with the performance of services).

The IRS recently issued proposed regulations that set forth some basic rules regarding Section 457(f) plans and which attempt to clarify the interaction between Section 457 and Section 83. These proposed regulations provide that if the deferred compensation is subject to a substantial risk of forfeiture, the amount includible in the participating employee's gross income for the first tax year in which

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Intermediate Sanctions

In 1995, Congress enacted the so-called "intermediate sanctions rules," under Section 4958 of the code, in order to combat certain abusive transactions involving tax-exempt organizations and their "insiders." Section 4958 provides that any "disqualified person" (DP) who benefits from an "excess benefit transaction" with a tax-exempt organization described in Code Sections 501(c)(3) or 501(c)(4) ("EO") will be subject to an excise tax equal to twenty-five percent of the "excess benefit." That person will also be liable for a tax of two hundred percent of the excess benefit if the transaction is not corrected by a certain date.

Earlier this year, the IRS issued final regulations which clarify certain definitions and rules contained in Section 4958. The following is a summary of some of the key provisions of the regulations.

A "disqualified person" includes any person in a position to exercise substantial influence over the affairs of the EO at any time during the five-year period ending on the date of the transaction at issue. A person who holds certain powers or responsibilities is treated as being in a position to exercise substantial influence; for example, an individual serving on the governing body of the EO who is entitled to vote on any matter, or a person who has ultimate responsibility for managing the finances of the organization.

A person who is not described in any of the categories enumerated by the regulations may nonetheless be a disqualified person depending upon all the facts and circumstances; for example, a person who was a substantial contributor to the EO or whose compensation is primarily based on revenues derived from those activities of the EO that the person controls, may be in a position to exercise substantial influence over the affairs of the organization.

An "excess benefit" is the amount by which the value of the economic benefit provided by an EO, directly or indirectly, to any DP exceeds the value of the consideration (including the performance of services) received by the EO for providing such benefit.

In determining the value of economic benefits for purposes of Section 4958, the value of property, including the right to use property, is its fair market value (i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell or transfer property, and both having reasonable knowledge of relevant facts). The value of services is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation).

Except for economic benefits that are specifically disregarded for purposes of Section 4958, compensation for purposes of determining reasonableness includes all economic benefits provided by an exempt organization in exchange for the performance of services, including, without limitation, all forms of cash and non-cash compensation (including salary, bonuses, severance payments, and deferred and non-cash compensation), the payment of liability insurance premiums for any penalty or tax under Section 4958, and all other compensatory benefits, whether or not included in gross income. The facts and circumstances to be taken into consideration in determining the reasonableness of a fixed payment generally are those existing on the date the parties enter into the contract pursuant to which the payment is made. In the case of a payment that is not a fixed payment under a contract, reasonableness is determined based on all the facts and circumstances up to and including the date of payment.

In determining whether an excess benefit transaction has occurred, all consideration and benefits (except certain enumerated disregarded benefits) exchanged between a DP and the EO, and all entities the EO controls, are taken into account. For example, in determining the reasonableness of compensation that is paid (or vests, or is no longer subject to a substantial risk of forfeiture) in one year, services performed in prior years may be taken into account. A transaction that would be an excess benefit transaction if the exempt organization engaged in it directly is likewise an excess benefit transaction when it is accomplished indirectly (for example, when it is provided through a controlled entity such as a stock corporation or a partnership).

An economic benefit is not treated as consideration for the performance of services unless the organization clearly indicates its intent to treat the benefit as compensation when paid. In general, an organization is treated as indicating this intent only if it provides written substantiation that is contemporaneous with the transfer of the economic benefit at issue. If it fails to do so, any services provided by the disqualified person will not be treated as consideration provided for the economic benefit.

Payments under a compensation arrangement are presumed to be reasonable, and a transfer of property or the right to use property is presumed to be at fair market value, if certain conditions are satisfied. Specifically, the arrangement must be approved in advance by an authorized body of the EO composed entirely of individuals who do not have a "conflict of interest" with respect to the compensation arrangement or property transfer (this may be obtained by a person's recusal from a meeting); this body must have obtained and relied upon appropriate data as to comparability prior to making its determination (e.g., information sufficient to determine whether compensation is reasonable); and it must have adequately documented the basis for its determination concurrently with making that determination.

Section 4958 will not apply to any fixed payment (an amount of cash or other property specified in the contract or determined by a fixed formula) that is made to a person pursuant to an **"initial contract"** which is to be paid or transferred in exchange for the provision of specified services or property. An initial contract means a binding written contract between an EO and a person who is not a DP immediately prior to entering into the contract.

"Organization managers" who participate in an excess benefit transaction knowingly, willfully and without reasonable cause will be liable for a tax of ten percent of the excess benefit. The tax for which all participating organization managers are liable cannot exceed $10,000 for any one excess benefit transaction.

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Deferred Compensation (cont'd)

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there is no substantial risk of forfeiture includes the earnings thereon to the date on which there is no risk of forfeiture. Any earnings credited on the deferred compensation after that time are includible in gross income only when paid or made available to the participant, provided that the interest of that participant in the assets of the tax-exempt employer is not senior to that of the employer's general creditors.

The regulations also provide that Section 457(f) does not apply to a compensatory transfer of property to which Section 83 applies. According to the proposed regulations, Section 457(f) does not apply if the date on which there is no substantial risk of forfeiture with respect to the deferred compensation is on or after the date on which there is a transfer of property to which Section 83 applies. However, Section 457(f) does apply if the date on which there is no substantial risk of forfeiture precedes the date on which there is a transfer of property to which Section 83 applies.

This latter provision may present an issue for those exempt organizations that utilize stock option programs to compensate key employees. Briefly, an exempt organization may grant to an employee a discounted option to purchase third-party securities. When the option is exercised, the employee recognizes ordinary income under Section 83. However, since such options are generally vested when granted (i.e., they are not subject to substantial risk of forfeiture), an argument can be made under the proposed regulations that Section 457(f) should be applied to tax the options to the employee on the date of grant. Hopefully, the final regulations will clarify this issue.

In general, the proposed regulations apply for tax years beginning after December 31, 2001. ◆

IRS Issues Revenue Ruling Addressing Split-Up of Private Foundations

by Deirdre M. Mitacek

Practitioners are frequently faced with a situation where the founder of a private foundation has died, and his or her children are now in control of the foundation's board of directors. Oftentimes, in the absence of the parent/founder's influence, the remaining directors decide that, for one reason or another, they cannot continue to work together to carry out the foundation's charitable purpose. Usually, the remaining directors agree to divide the foundation's assets and distribute them to newly formed foundations, each run by a separate faction of the dissolving foundation's board of directors.

The practitioner's role, generally, is to separate the dissolving private foundation into two or more foundations without triggering the so-called "termination tax" (applicable to a foundation that loses its tax exempt status) or any of the excise taxes imposed on private foundations. While the situation is quite common, as demonstrated by the volume of private letter rulings issued on the subject, until recently there had been no official pronouncement by the Internal Revenue Service (the "IRS") on how to accomplish a tax-free dissolution of a private foundation.

Earlier this year, the IRS issued Revenue Ruling 2002-28 to provide guidance on the tax consequences of the division of a private foundation into two or more newly formed private foundations. The Revenue Ruling, which is intended to act as a safe harbor and reduce the number of ruling requests that the IRS receives on the dissolution of private foundations, may be less effective than the IRS intended insofar as it addresses a fairly simple fact pattern and leaves certain issues, described below, unresolved.

The following scenario was presented in the Revenue Ruling: The directors of a private foundation, P, have divergent charitable goals. Pursuant to a plan of dissolution, P distributes all of its net assets in equal shares to three private foundations, X, Y and Z. The day after P distributes all of its assets, it files articles of dissolution with the appropriate state authority. We are told to assume that all three of the transferee private foundations are "effectively controlled," directly or indirectly, by the same persons who controlled the transferor foundation.

Generally, a private foundation that terminates its foundation status is subject to a tax equal to the lower of the value of the foundation's net assets at the time of the termination or the amount of the aggregate tax benefit resulting from the foundation's exempt status. The Revenue Ruling states that a private foundation can avoid this termination tax by distributing its net assets prior to the time that it notifies the Commissioner that it is terminating its status as a private foundation. (Under Federal law, a corporation's status as a private foundation does not terminate until the corporation notifies the commissioner of the termination, regardless of whether the corporation has dissolved for state law purposes.)

After addressing the termination tax issue, the ruling goes on to discuss whether the dissolving foundation would be subject to any of the excise taxes imposed on private foundations as a result of the split-up.

The Revenue Ruling holds that the transfer of the foundation's assets to the new foundations would not constitute self-dealing or a jeopardizing investment. The Revenue Ruling further states that whether the transfer resulted in excess business holdings is a facts-and-circumstances determination that must be made on a case-by-case basis.

In determining the effect of the transfer on a number of other issues, the Revenue Ruling assumes away the most difficult issue. Under the Treasury Regulations, how the transferor and the transferee foundations are treated depends in large part upon whether the transferee foundations are "effectively controlled" (as defined in under Section 482 of the Code) by the same person or persons who controlled the transferor foundation. If the transferor and the transferee foundations are under common control, then the transferee foundations are treated as a continuation of the terminating foundation for purposes of the tax on undistributed income and for purposes of the taxable expenditure rules. Based upon its assumption that the transferee foundations are under common control, the Revenue Ruling states that the transfers to the transferee foundations will not be treated as qualifying distributions nor will the transfers be subject to expenditure responsibility.

The Ruling posits that the foundation will split up into three foundations that are controlled by the same person or persons who controlled the old foundation. This seems to represent an unrealistic scenario, even under a Section 482 reading of the term "control." In light of the fact that most private foundation split-ups originate in the inability of the directors to work together, it is more likely that the transferee foundations would not be under common control. Because the

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IRS Issues Revenue Ruling (cont'd)

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Revenue Ruling assumes control rather than defining it, many taxpayers, unsure of whether common control exists, likely will continue to request a ruling in order to determine the terminating and the transferee foundations' on-going responsibilities.

Moreover, the Revenue Ruling fails to resolve the issue of whether a terminating foundation must exercise expenditure responsibility over the assets transferred to the transferee foundations' in the split-up. The Revenue Ruling's analysis suggests that P is not required to exercise expenditure responsibility over the transfers because the transferee foundations are under common control. Prior letter rulings, however, have stated that the terminating foundation is not required to exercise expenditure responsibility because a foundation that has no assets is not required to exercise expenditure responsibility over any grants, regardless of whether the transferor and the transferee foundations are under common control. While the Revenue Ruling recognizes this alternative rule, it does so only in connection with the terminating foundation's other outstanding grants, which it seems to distinguish from the transfers to the transferee foundations in the split-up. The fact that the Revenue Ruling does not clearly state that a terminating foundation will not have to exercise expenditure responsibility over assets transferred in the split-up, regardless of whether such foundations are commonly controlled, further lessens the usefulness of the Revenue Ruling as a safe harbor. ◆

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An organization manager includes any officer, director, or trustee of the EO, or any individual having powers or responsibilities similar to those of an officer, director, or trustee, or any person who regularly exercises general authority to make administrative or policy decisions on behalf of the EO.

"Participation" includes silence or inaction on the part of the manager where the manager is under a duty to speak or act, as well as any affirmative action by such manager. A 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 EO.

A manager will be considered to have participated in a transaction knowingly only if he had actual knowledge of sufficient facts so that, based on such facts, he was aware that such a transaction may violate the Federal tax law regarding excess benefit transactions, and he negligently failed to make reasonable attempts to ascertain whether the transaction was an excess benefit transaction. A manager's participation ordinarily is not considered "knowing" to the extent that, after full disclosure of the factual situation to an appropriate professional (e.g., an independent valuation expert), the manager relies on a reasoned written opinion of that professional with respect to elements of the transaction within the professional's expertise.

"Willful" means voluntary, conscious and intentional; participation will not be willful if the manager does not know that the transaction is an excess benefit transaction. Participation is due to reasonable cause if the manager has exercised responsibility on behalf of the EO with ordinary business care and prudence.

An excess benefit transaction is corrected by undoing the excess benefit to the extent possible and taking any additional measures necessary to place the EO in a financial position not worse than that in which it would be if the DP were dealing under the highest fiduciary standards. In general, a DP corrects an excess benefit only by making a payment in cash or cash equivalents, excluding payment by a promissory note, to the EO of an amount equal to the correction amount. The correction amount is equal to the sum of the excess benefit and interest on the excess benefit.

Where the EO that engaged in the excess benefit transaction no longer exists or is no longer described in Section 501(c)(3), the DP must pay the correction amount to another organization described in Section 501(c)(3), provided that the organization has been in existence and so described for a continuous period of at least sixty calendar months, the DP is not a disqualified person with respect to that organization, and the organization receiving the correction amount does not allow the DP to make or recommend any grants or distributions by the organization.

An exempt organization is subject to these rules if it is described in Sections 501(c)(3) or 501(c)(4) of the Code, or if it was described in such sections and was exempt from tax at any time during a five-year period ending on the date of an excess benefit transaction. The final regulations are applicable as of January 23, 2002.

It is safe to say that the IRS will apply these regulations vigorously. Moreover, it is likely that additional regulations will be issued dealing with those excess benefit transactions that may cause an EO to lose its favored tax status.

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