

ALI-CLE
Tax Exempt Organizations: An Advanced Course
October 18-19, 2012

EXCESS BENEFIT TRANSACTIONS
AND INTERMEDIATE SANCTIONS

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EXCESS BENEFIT TRANSACTIONS AND INTERMEDIATE SANCTIONS

Under Section 4958 of the Internal Revenue Code of 1986, as amended (the “Code”), the IRS may impose penalty taxes (commonly referred to as “intermediate sanctions”) on “disqualified persons” and “organization managers” when “applicable tax exempt organizations” engage in “excess benefit transactions” with disqualified persons.

Following, in a question and answer format, is an explanation of excess benefit transactions and intermediate sanctions.¹

A. THE BASIC ELEMENTS OF INTERMEDIATE SANCTIONS

1. What are the “applicable tax-exempt organizations”?

Because intermediate sanctions do not apply to all types of tax-exempt organizations, an exempt organization should first consider whether it is subject to intermediate sanctions. Applicable tax-exempt organizations are:

- *Public charities*: those exempt under Section 501(c)(3) and classified as public charities under Section 509(a), including Section 509(a)(3) supporting organizations.²
- *Social welfare organizations*: those exempt under Section 501(c)(4) or holding themselves out as such.

The following types of organizations, however, are *not* subject to intermediate sanctions:

- *Private foundations*: those exempt under Section 501(c)(3) and classified as private foundations under Section 509(a). (Note that private foundations are subject to other excise taxes on self-dealing under Section 4941 and on taxable expenditures under Section 4945.)
- *Certain tax-exempt foreign organizations*: those that receive substantially all of their support from sources outside the United States.

¹ Unless otherwise noted, this material is drawn from Code Section 4958 and the Treasury Regulations under Code Section 4958 (Treas. Reg. §§ 53.4958-0 through 53.4958-8) (the “Regulations”).

² All “Section” references are to sections of the Code, unless otherwise indicated.

- *Quasi-Governmental entities*: those exempt from (or not subject to) taxation even if they have applied for Section 501(c)(3) status.

2. **Who (or what) is a “disqualified person” with respect to an applicable organization?**

Intermediate sanctions concern transactions between an applicable tax-exempt organization and certain individuals and entities called “disqualified persons.” Before engaging in a transaction, therefore, an applicable organization should determine whether the other party to the transaction is a disqualified person. (It is important to note that the definition of a “disqualified person” for purposes of intermediate sanctions is different from the definition under the self-dealing rules applicable to private foundations.)

For purposes of intermediate sanctions, a “disqualified person” is any person in a position to exercise substantial influence over the affairs of the organization at any time during the five-year period prior to the transaction at issue. Some persons, by nature of their positions within the organization, are automatically considered disqualified persons. Others may be classified as disqualified persons on the basis of all relevant facts and circumstances.

Disqualified persons by definition

- *A person with “substantial influence”* — identified as:
 - a voting member of the governing body (such as the board of directors);
 - a person with the power or responsibilities of president, chief executive officer, chief operating officer, treasurer or chief financial officer;
 - a person with a material financial interest in a “provider-sponsored organization” (as defined in the Social Security Act, an entity similar to a health maintenance organization), in which a hospital that is subject to intermediate sanctions participates;
- *A family member of a person with substantial influence* — identified as such person’s spouse, ancestors, siblings, children, grandchildren, great grandchildren, and spouses of siblings, children, grandchildren and great grandchildren;
- *A 35-percent controlled entity* — defined as a corporation, partnership, trust or estate in which persons with substantial influence or their family members own more than 35 percent of the voting power, profits interest or beneficial interest;

- With respect to a supporting organization – all substantial contributors (other than a Section 509(a)(1) or (a)(2) public charity), their family members, and their 35-percent controlled entities (see special rules below);
- A disqualified person of a supporting organization – defined as any person described above with respect to a supporting organization described in Section 509(a)(3) that benefits or supports the applicable tax-exempt organization (i.e., a disqualified person of a supporting organization also is a disqualified person of the supported organization);
- With respect to a donor-advised fund - all donors and donor advisors, their family members, and their 35-percent controlled entities (see special rules below);
- With respect to an organization that sponsors donor-advised funds – its investment advisors, their family members, and their 35-percent controlled entities.

Persons who, by definition, are not disqualified persons

The Regulations also identify persons and entities which, by virtue of their status, are deemed not to have substantial influence and thus are not disqualified persons. They include:

- Tax-exempt organizations described in Section 501(c)(3), including private foundations;
- A Section 501(c)(4) organization with respect to another Section 501(c)(4) organization;
- Any employee of the organization who:

receives from the organization annual economic benefits (including compensation and all other economic benefits) that are less than \$115,000 (adjusted annually for inflation);³

is not a person with substantial influence or a family member of such a person; and

is not a “substantial contributor” (a person who within the current year and four preceding years contributed an aggregate amount exceeding both (i) \$5,000 and (ii) 2 percent of the total received by the organization during that five-year period).

³ \$115,000 is the amount in effect for 2012. IRS Notice 2011-103 (Oct. 20, 2011).

Disqualified persons under the “facts and circumstances” test

If a person is not a disqualified person, *per se*, or is not expressly excluded from the definition of a disqualified person, then all relevant facts and circumstances will be used to determine whether the person, in fact, has “substantial influence” over the organization. A person who has substantial influence over an organization is a disqualified person with respect to that organization.

Substantial influence indicators: Facts and circumstances that tend to show a person has substantial influence include, but are not limited to, situations in which the person:

- founded the organization;
- is a substantial contributor (as defined above);
- receives compensation based primarily on revenues derived from organization activities that the person controls;
- has authority to determine a significant portion of the organization’s capital expenditures, operating budget, or compensation for employees;
- has managerial authority over a discrete segment or activity of the organization that represents a substantial portion of the organization’s activities, assets, income, or expenses;
- owns a controlling interest in a corporation, partnership or trust that is a disqualified person;
- is a non-stock organization controlled by a disqualified person.

Under the Regulations, a management company is considered a disqualified person if it has broad discretion to manage an applicable tax-exempt organization's day-to-day operations and has ultimate responsibility for supervising the organization's management.

If it is determined that the transacting party is indeed a disqualified person, the organization must avoid engaging in an excess benefit transaction.

3. What is an “excess benefit transaction”?

An “excess benefit transaction” is any transaction in which a disqualified person receives an economic benefit that exceeds the value of the services, property or payment the organization receives in return. For example, excess benefit transactions include (i) the payment of unreasonable compensation for services performed by a disqualified person and (ii) the purchase of property from a disqualified person at a price greater than fair market value.

An excess benefit transaction may occur even if the disqualified person receives excessive payment from another entity that is affiliated with the organization, or through an intermediary third party that receives the payment from the organization and in turn provides economic benefits to the disqualified person.

Special rules apply to donor-advised funds and supporting organizations

Excess benefit transactions include any grant, loan, compensation, or other similar payment (i) from donor-advised funds to their donors or donor advisors, family members of donors and donor advisors, and their 35-percent controlled entities, and (ii) by supporting organizations to any substantial contributors, family members of such contributors, or their 35-percent controlled entities. In addition to loans described above, any loan by a supporting organization to a disqualified person is an excess benefit transaction. Note that, for the types of transactions described above, the entire amount of the payment is an excess benefit, even if the payment is reasonable.

Certain revenue-sharing transactions, such as incentive compensation based on the organization's revenues, are susceptible to excess benefit classification and thus are subject to considerable scrutiny (see below regarding revenue-based transactions).

Exception for fixed payments made pursuant to an initial contract

The Regulations explicitly exclude from the definition of excess benefit transactions fixed payments made pursuant to a binding written contract with a party who was not a disqualified person immediately prior to entering into the contract. This rule may apply, for example, to an employment contract between an organization and a new chief executive officer. A fixed payment is an amount of cash or other property that is specified in the contract or determined by a fixed formula provided in the contract. A cap on the amount of payment does not, by itself, qualify a discretionary payment as “fixed.”

The exception for initial contracts does not apply to:

- a contract subject to cancellation by the organization without requiring the consent of the other party and without substantial penalty to the organization;
- a contract to which the parties make a material change (*e.g.*, the parties extend or renew the contract, or make a more than incidental change to the amount payable);
- a situation in which the party contracting with the organization fails to perform substantially its obligations under the contract.

Economic benefits *not* subject to intermediate sanctions

Certain economic benefits provided to a disqualified person are disregarded for purposes of intermediate sanctions:

- benefits received solely as a volunteer for the organization, if the benefit is provided to the public for an annual membership fee or contribution of \$75 or less;
- benefits received as a member or donor of the organization, if the benefit is provided to the member or donor solely on account of payment of a membership fee;
- benefits received solely as a member of a charitable class that the organization intends to benefit;
- benefits transferred to or for the use of a governmental unit if the transfer is for exclusively public purposes;
- certain payments made pursuant to a “final individual prohibited transaction exemption” issued by the Department of Labor under ERISA;
- nontaxable fringe benefits, except liability insurance premiums and payments or reimbursements that are included for purposes of determining whether compensation is reasonable (see below); and
- reimbursement of business expenses or other expense allowance payments made pursuant to an “accountable plan.”

Accordingly, payment of reasonable and necessary expenses for governing body members to attend meetings is a disregarded economic benefit. Also note that premium payments for liability insurance to cover intermediate sanctions excise taxes (and indemnification for such

taxes) are included as part of the determination of reasonable compensation, and thus are not disregarded benefits.

B. WHAT IS CONSIDERED COMPENSATION FOR PURPOSES OF INTERMEDIATE SANCTIONS?

Compensation is defined as all consideration given in exchange for performance of services, including but not limited to:

- salary, fees, bonuses, and severance payments, whether paid in cash or in kind;
- benefits provided pursuant to a qualified pension, profit-sharing or stock bonus plan;
- premiums paid for liability insurance, as well as any payment or reimbursement by the organization of:

any penalty, tax or expense of correction owed under the intermediate sanctions rules;

any expense not reasonably incurred by the person in connection with a civil proceeding arising out of the person's performance of services on behalf of the organization;

any expense resulting from an act or failure to act with respect to which the person acted willfully and without reasonable cause;

- all other benefits, whether or not included in taxable income, including payments to health and welfare benefit plans, such as medical, dental, life insurance, severance pay and disability benefit plans, and most fringe benefits (other than expense allowances or reimbursements pursuant to an "accountable plan") and forgiven interest on loans.

An organization must clearly establish its intent to treat an economic benefit as compensation.

Written contemporaneous substantiation

The Regulations specify that an organization must clearly indicate its intent to provide an economic benefit as compensation for services by written substantiation that is contemporaneous with the payment or transfer of the benefit.

Written contemporaneous substantiation includes:

- reporting of the benefit either by (i) the exempt organization on an original or amended Form W-2, 1099, or 990 or (ii) the disqualified person on an original or amended Form 1040; provided that these forms are filed before the IRS commences an audit, and in the case of an amended return by a disqualified person, also before the IRS documents a potential excess benefit transaction;
- written employment contract executed on or before the date of the transfer;
- documentation indicating that an authorized body approved the transfer as compensation for services on or before the date of the transfer; and
- written evidence, which existed on or before the due date of the applicable Federal tax return (Form 990, W-2, 1099 or 1040), upon which the organization based a reasonable belief (as defined in the Regulations) that a benefit is nontaxable (and therefore not treated as compensation for purposes of intermediate sanctions).

Special rules for revenue-based transactions

A revenue-sharing or revenue-based transaction occurs when the economic benefit to a disqualified person is determined in whole or in part by the revenue of one or more of the organization's activities. Such transactions include, for example:

- an in-house investment manager who receives a payment equal to a percentage of the annual increase in the portfolio's value;
- a company that manages an organization's charitable gaming activities and receives a set percentage of net profits;
- a professor who receives a payment equal to a percentage of patent royalties paid to the university on an invention owned by the university but created by the professor.

The IRS and Treasury Department have stated that they will continue to consider how to apply intermediate sanctions to revenue-based transactions. For the time being, however, the IRS will evaluate revenue-based transactions under the general rules defining excess benefit transactions, *i.e.*, on the basis of reasonableness. In addition, the Regulations provide that the existence of a cap on the amount due a disqualified person, whether under a revenue-based arrangement or otherwise, is a relevant factor in determining the reasonableness of compensation.

C. AUTOMATIC EXCESS BENEFIT TRANSACTIONS⁴

1. What are “automatic excess benefit transactions”?

As stated above, an economic benefit provided by an applicable tax-exempt organization to a disqualified person is treated as compensation only if the organization clearly indicates its intent to treat the benefit as compensation for services when the benefit is paid. If the benefit that should be treated as compensation is not treated as compensation, the IRS will treat the benefit as an automatic excess benefit transaction. An automatic excess benefit transaction occurs without regard to whether:

- the economic benefit is reasonable;
- any other compensation the disqualified person may have received is reasonable; or
- the aggregate of the economic benefit and any other compensation the disqualified person may have received is reasonable.

2. How can an automatic excess benefit transaction be avoided?

To avoid automatic excess benefit transactions, an exempt organization or a disqualified person should review all economic benefits that the exempt organization provides to the disqualified person to determine:

- whether the benefits fall within one of the exceptions to the definition of compensation for purposes of intermediate sanctions (see pages 5-7, above), such as expense reimbursements under an accountable plan and certain nontaxable fringe benefits; or
- whether the benefits are included in a written employment contract executed on or before the date of the transfer.

If a benefit does not fall within one of the exceptions, the exempt organization should report the compensation on its Form 990 or 990-PF. The exempt organization also should include the value of any taxable benefit on the Form W-2 or the Form 1099 that it issues to the disqualified person, and the disqualified person should include the value of the benefit on his or her Form 1040.

⁴ Laurence M. Brauer & Leonard J. Henzke, Jr., “Automatic” Excess Benefit Transactions under IRS 4958, IRS Exempt Organizations Continuing Professional Education Technical Instruction Program (Dec. 19, 2003).

D. HOW CAN INTERMEDIATE SANCTIONS BE AVOIDED?

The key to avoiding the penalties of intermediate sanctions is to establish that the compensation or transaction is “reasonable.”

Compensation is reasonable only if a like enterprise would ordinarily pay such an amount for like services under like circumstances. For fixed payments, the circumstances to be considered are generally those existing on the date the contract was made. In the case of a payment that is not fixed under the contract, such as a bonus payment that the governing body may declare in its discretion, reasonableness is determined based on all facts and circumstances, up to and including circumstances as of the date of payment. These general timing rules also apply to property subject to a substantial risk of forfeiture. Certain modifications to or provisions in a contract may trigger special rules concerning the appropriate time for determining the reasonableness of the compensation. The fact that a state or local legislative body or agency, or a court, authorized or approved the compensation does not determine reasonableness. Thus fees of trustees or others set by statute or approved by a court may not be reasonable for purposes of intermediate sanctions.

What is the “rebuttable presumption of reasonableness”?

The Regulations enable an organization to establish a rebuttable presumption of reasonableness by satisfying three criteria. If all three criteria are met, the IRS will not impose excise taxes unless it develops additional information showing that the compensation was not reasonable or that the transfer was not at fair market value. The lack of a rebuttable presumption, however, will not support an inference that an excess benefit transaction has occurred.

The three criteria for establishing a rebuttable presumption of reasonableness are:

1. Governing body or committee approval

The transaction must be approved by the organization's governing body (*e.g.*, board of directors), or a committee thereof, composed entirely of persons without a conflict of interest with respect to the transaction. A board or committee member with a conflict must recuse himself from the meeting and may not be present other than to answer questions.

Committee

A committee of a governing body may be composed of any individuals permitted under state law to serve on such a committee and may act on behalf of the governing body to the extent permitted by state law.

Conflict of interest

A member of a governing body or committee has a conflict of interest with respect to a transaction if the member:

- is a disqualified person or a family member of any disqualified person participating in or economically benefiting from the transaction;
- is in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefiting from the transaction;
- is receiving compensation or other payments subject to approval by any disqualified person participating in or economically benefiting from the transaction;
- has a material financial interest affected by the transaction; or
- approves a transaction providing economic benefits to any disqualified person participating in the transaction, who in turn has approved or will approve a transaction providing economic benefits to the member.

Because the Regulations cast a wide net, any organization subject to them should review its existing conflicts of interest policy to ensure that it reflects these standards.

2. Comparability data

The governing body or committee must rely on appropriate data in determining the reasonableness of the compensation or value of the transferred property.

Appropriate comparability data include:

- compensation paid by similarly situated organizations, both taxable and tax-exempt, for comparable positions;
- availability of similar services in the area;
- compensation surveys compiled by independent firms;

- actual written offers from similar organizations competing for the services of the disqualified person, or, in the case of property, offers received as part of an open and competitive bidding process;
- independent appraisals of the value of property involved.

Safe harbor for small organizations

When the governing body or committee of an organization with annual gross receipts of less than \$1 million (based on a three-year average) reviews compensation, the data will be considered appropriate if it includes information on compensation paid by three comparable organizations in similar communities for similar services. If the organization is affiliated with another entity by common control or governing documents, the annual gross receipts of all such organizations must be aggregated.

3. Adequate documentation

The governing body or committee must adequately document the basis for its determination concurrently with making the determination.

Content of the records

Documentation is adequate if the written or electronic records of the governing body or committee note:

- the terms and date of the approved transaction;
- the members present during the debate on the approved transaction and who voted on it;
- comparability data obtained and relied upon by the governing body or committee and how the data was obtained;
- actions with respect to consideration of the transaction by anyone who is a member of the governing body or committee but who had a conflict of interest with respect to the transaction; and
- if the governing body or committee determines that reasonable compensation or fair market value is higher or lower than the range of comparable data obtained, the basis for the determination.

Timing of records preparation and review

The basis for a determination must be documented concurrently with the making of such determination. This means the records described above must be prepared before the later of (i) the next meeting of the governing body or committee after the determination is made or (ii) 60 days after the final actions of the governing body or committee are taken. The records must then be reviewed and approved by the governing body or committee as reasonable, accurate and complete within a reasonable time period.

Special rules for non-fixed payments

Generally the rebuttable presumption of reasonableness with respect to non-fixed payments will arise only after the exact amount of payment, or a fixed formula for calculating the payment, is determined. In the case of employment contracts with disqualified persons, if the governing body or committee approves a non-fixed payment subject to a specified cap, a rebuttable presumption of reasonableness may be established at the time the contract is entered into if:

- the governing body obtains comparability data indicating that a fixed payment of up to a certain amount would be reasonable;
- the cap does not exceed that amount; and
- the other requirements for the rebuttable presumption of reasonableness are satisfied.

E. EXCISE TAXES

1. What transactions are subject to the excise tax?

The excise taxes apply to excess benefit transactions, including automatic excess benefit transactions, that occur on or after September 14, 1995. Note that the excise taxes do not apply to any transaction undertaken pursuant to a written contract that was binding on September 13, 1995, until the date such transaction occurred. (However, certain modifications to or provisions in such a contract regarding termination of the contract may nullify this exception.)

2. If an excess benefit transaction occurs, who is responsible for payment of the tax?

The penalty excise taxes are the responsibility of the disqualified persons and organization managers, not the organization.

3. What are the excise taxes on disqualified persons?

First tier

A tax equal to 25 percent of the excess benefit will be imposed on all disqualified persons involved in each excess benefit transaction.

Second tier

If the transaction is not “corrected” within a certain time period, an additional tax equal to 200 percent of the excess benefit also will be imposed on any disqualified person who received an excess benefit. In the event that the disqualified person makes a payment of less than the full correction amount, the 200 percent tax is imposed only on the unpaid portion.

Correction of an excess benefit transaction

In addition to the payment of any applicable excise taxes, a disqualified person who receives an excess benefit is required to correct the transaction by undoing the excess benefit to the extent possible. Such correction would include any additional measures necessary to place the organization in a financial position not worse than that in which it would have been if the disqualified person had been dealing under the highest fiduciary standards. For example, correction might consist of repaying an amount needed to compensate the organization for the loss of the use of the money or property.

Abatement of the excise taxes on disqualified persons

The IRS will abate the first tier tax if the excess benefit transaction is corrected within the “correction period” and the IRS is satisfied that the transaction was due to reasonable cause and not to willful neglect. The IRS also will abate the second-tier tax if the transaction is corrected within the correction period. Generally, the correction period begins on the date the transaction occurs and ends 90 days after the date the IRS mails a notice of deficiency for the second-tier tax.

4. What are the excise taxes on organization managers?

An excise tax applies to organization managers who participate, including by silence or inaction, in a transaction knowing that it is an excess benefit transaction, unless such participation was not willful and was due to reasonable cause. An organization manager's participation is not ordinarily considered “knowing” if the requirements giving rise to the rebuttable presumption of reasonableness are satisfied.

With respect to each excess benefit transaction, organization managers are jointly and severally liable for a tax equal to 10 percent of the excess benefit (up to a maximum of \$10,000). If the organization manager is also a disqualified person in the excess benefit transaction, he will be subject to the taxes applicable to disqualified persons, as well as those applicable to organization managers.

Persons identified as organization managers:

- any officer, director or trustee of the organization, or any individual having powers or responsibilities similar to those of such officers, directors, or trustees;
- any individual who serves on a committee of the governing body of an organization that is invoking the rebuttable presumption of reasonableness based on the committee's action.

Persons who are *not* organization managers:

- any independent contractor acting in a capacity as attorney, accountant, or investment manager or advisor;
- any person who has authority merely to recommend particular administrative or policy decisions but not to implement them without approval of a superior.

Advice of legal counsel or certain other professionals as a shield from the excise tax

An organization manager, after full disclosure of the factual situation to legal counsel (including in-house counsel), a certified public accountant, or an independent qualified valuation expert, may rely on a reasoned written opinion of such professional that the transaction is not an excess benefit transaction.

5. Joint and several liability

If more than one disqualified person or organization manager is liable for any intermediate sanctions excise tax, all such persons are jointly and severally liable for the tax. In other words, the IRS can collect the aggregate tax from any one or all of the persons who are liable, in equal or unequal amounts.

6. How are the excise taxes reported to the IRS?

Form 990: An exempt organization that files a Form 990 (Return of Organization Exempt from Income Tax) must answer the following questions in Part IV, Lines 25a and 25b if it is tax-exempt under Code Section 501(c)(3) or 501(c)(4):

Did the organization engage in an excess benefit transaction during the year with a disqualified person during the year? ... Is the organization aware that it engaged in an excess benefit transaction with a disqualified person in a prior year, and that the transaction has not been reported on any of the organization's prior Forms 990 or 990-EZ?

If the organization answers "yes" to either question, it must complete Form 990 Schedule L, Part I, describing each excess benefit transaction, including identification of the disqualified person or persons and whether the excess benefit transaction has been corrected. Note that Line 25 addresses not only transactions occurring in the tax year reported on the Form 990 but also any transaction occurring prior to the tax year that the organization becomes aware of during that tax year. In addition, if the organization answers "yes" to Line 25a or 25b, it must report the total excise tax amount imposed on the organization managers or disqualified persons during the year on Schedule L.

Form 4720: A disqualified person or an organization manager who is liable for an intermediate sanctions excise tax must file a Form 4720 (Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code).⁵ Anyone required to file a Form 4720 who does not file the Form 4720 or fails to pay the excise tax may be subject to additional penalties, such as penalties for failure to file a tax return⁶ or to pay the tax.⁷

F. IS REVOCATION OF TAX-EXEMPT STATUS STILL POSSIBLE IF INTERMEDIATE SANCTIONS ARE IMPOSED?

If the IRS determines that an organization is not operating for an exempt purpose, the IRS may apply intermediate sanctions and also revoke the organization's tax-exempt status. Note that revocation of exempt status still applies even if a transaction is not subject to intermediate sanctions. For example, even though a fixed payment pursuant to an initial

⁵ Section 6011(a).

⁶ Section 6651(a)(1); Treas. Reg. § 301.6651-1(a)(1).

⁷ Section 6651(a)(3); Treas. Reg. § 301.6651-1(a)(3).

contract is not covered by intermediate sanctions, the IRS could still revoke the organization's exempt status if circumstances warranted. An IRS representative has stated that guidance should be issued in the spring of 2005 illustrating the facts and circumstances that would lead the IRS to both revoke an organization's tax-exempt status and apply intermediate sanctions.⁸

G. ARE THERE SPECIAL RULES FOR CHURCHES?

The procedures restricting church tax inquiries and examinations by the IRS under Section 7611 of the Code apply to inquiries into potential excess benefit transactions between a church and a disqualified person.

⁸ Fred Stokeld, *IRS's Exempt Organization Enforcement Projects Coming Along Sullivan Says*, 2005 TNT 14-11 (Jan. 24, 2005) (reporting on comments by Martha Sullivan, IRS Exempt Organizations Division Director).