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CHAPTER 5

Rebuttable Presumption of Reasonableness

One of the most intriguing aspects of the intermediate sanctions rules is the *rebuttable presumption of reasonableness*. It is a stunning exception to a fundamental federal tax law principle: The burden of proof in a tax dispute is on the taxpayer. That is, the burden of proof is rarely on the government (the IRS).

In the intermediate sanctions context, however, the rebuttable presumption of reasonableness can be used to shift the burden of proof to the IRS. The advantages to that are manifold and certainly obvious. Also, this presumption contains elements of operations that a tax-exempt organization should follow generally as part of prudent management.

§ 5.1 CONCEPT OF REBUTTABLE PRESUMPTION

(a) Presumptions Generally

The word *presumption* means a type of inference. A presumption can be used in an attempt to reach a conclusion of fact even though all relevant underlying facts have not been formally proved. More specifically, a presumption is an inference as to the existence of one or more facts that are not certainly known from the proved existence of one or more other facts. It can be embodied in a rule of procedure as to which party has the burden of proof in the context of a dispute.

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A presumption, then, can shift the burden of proof from the party satisfying the terms of the presumption to the other party to the dispute. The rules involved, however, may allow that other party to muster certain facts that shift the burden of proof back to the original party. That process is known as *rebutting the presumption*. Some presumptions are *absolute* (i.e., they give rise to an uncontestable conclusion of fact), and some are *rebuttable*.

(b) Intermediate Sanctions Rebuttable Presumption

The law of intermediate sanctions includes a rebuttable presumption of reasonableness. This presumption means that, where certain facts are in place, the burden of proving that a transaction is an excess benefit transaction[1] is shifted to the IRS. The IRS, however, as the term reflects, can rebut this presumption.[2] In that event, the burden of proof on the issue is bounced back to the disqualified person or persons.[3]

Pursuant to the rebuttable presumption of reasonableness, a payment by an applicable tax-exempt organization to a disqualified person under a compensation arrangement is presumed to be reasonable where three conditions are satisfied. The same is true with respect to a transfer of property or the right to use property, which is presumed to be at fair market value. The three conditions are:

1. The compensation arrangement or the terms of the property transfer are approved in advance by an authorized body of the applicable tax-exempt organization[4] (or a controlled entity[5]), composed entirely of individuals who do not have a conflict of interest[6] with respect to the compensation arrangement or property transfer.
2. The authorized body obtained and relied on appropriate data as to comparability prior to making its determination.[7]
3. The authorized body adequately documented the basis for its determination concurrently with making the determination.[8]

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[1] See Chapter 4.
[2] See *infra* § 5.
[3] See Chapter 3.
[4] See *infra* § 2.
[5] See § 4.2.
[6] See *infra* § 3.
[7] See *infra* § 4.
[8] See *infra* § 5. Also Reg. § 53.4958-6(a).

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Oddly, the authorization for the rebuttable presumption is not in a statute. Congress created it by providing for it in the legislative history of the intermediate sanctions law.[9] The presumption is also contained in, and substantially embellished by, the tax regulations.[10]

§ 5.2 AUTHORIZED BODIES

As noted, the first prong of the rebuttable presumption of reasonableness requires that the compensation arrangement or the terms of the transfer of property be approved in advance by an authorized body of the applicable tax-exempt organization (or a controlled entity), composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement or property transfer.

An *authorized body* of an applicable tax-exempt organization is one of three groups of individuals:

1. The organization's governing body, that is, its board of directors, board of trustees, or equivalent controlling body
2. A committee of the governing body, which may be composed of any individuals permitted under state law to serve on this type of a committee, to the extent that the committee is permitted by state law to act on behalf of the governing body[11]
3. To the extent permitted under state law, other parties authorized by the governing body of the organization to act on its behalf, by following procedures specified by the governing body in approving compensation arrangements or transfers of property[12]

For purposes of determining whether the rebuttable presumption is available in connection with a specific compensation arrangement or property transfer, an individual is not included on the authorized body, when it is reviewing a transaction, if that individual meets with other members only to answer questions and otherwise recuses himself or herself from the

[9] See § 1.2(a).
[10] Reg. § 53.4958-6.
[11] If state law permits, this committee can consist of one individual (67 Fed. Reg. 3082 (Jan. 23, 2002)).
[12] Reg. § 53.4958-6(c)(1)(i).

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meeting and is not present during the debate and voting on the compensation arrangement or property transfer.[13]

In this context, the term *independent board* often is used. This is an informal term, usually invoked in the context of the intermediate sanctions rules. Generically, it means a board of directors or trustees, the members of which do not have any family or business ties with the individual whose compensation package is under review or who has received property or the use of property from the applicable tax-exempt organization. Generally an independent board is one in which *all* of its members are independent of the individual involved in the arrangement under review. This requirement is reflected in the first of the rebuttable presumption criteria, which states that the authorized body must be composed *entirely* of individuals who do not have a close relationship with the individual involved.[14]

The rebuttable presumption does not use the terminology as to "family or business ties" but rather invokes a concept of *conflict of interest* (or lack thereof).[15]

Likewise, the term *captive board* often is used. The term *captive board*, like the term *independent board*, is an informal one; it is not formally used in connection with the rebuttable presumption. The term means a governing body, one or more members of which have a close family or business relationship with the individual whose compensation package is under review or who has received property or the use of property from the applicable tax-exempt organization.

§ 5.3 CONFLICTS OF INTEREST

As noted,[16] the intermediate sanctions rules state the matter of the *independence* of board members of applicable tax-exempt organizations in terms of whether the individuals involved have or lack a *conflict of interest*.[17] The rules state the matter of a conflict of interest in the negative. That is, a member of an authorized body does not have a conflict of interest with respect to a

[13] Reg. § 53.4958-6(c)(1)(ii).
[14] Reg. § 53.4958-6(a)(1).
[15] See *infra* § 3.
[16] See *supra* § 2.
[17] This use of the concept of conflict of interest was introduced by the tax regulations. That is, the concept is not found in the statute or in the legislative history.

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compensation arrangement or property transfer only if the member satisfies all of these requirements:

- Is not a disqualified person participating in or economically benefiting from the compensation arrangement or property transfer, and is not a member of the family of any such disqualified person[18]
- Is not in an employment relationship subject to the direction or control of any disqualified person participating in or economically benefiting from the compensation arrangement or property transfer
- Does not receive compensation or other payments subject to approval by any disqualified person participating in or economically benefiting from the compensation arrangement or property transfer
- Has no material financial interest affected by the compensation arrangement or property transfer
- Does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement or property transfer, who in turn has approved or will approve a transaction providing economic benefits to the member[19]

§ 5.4 APPROPRIATE DATA

The second prong of the rebuttable presumption of reasonableness is that the authorized body has obtained and relied on appropriate data as to comparability prior to making its determination.

An authorized body has *appropriate data as to comparability* if, given the knowledge and expertise of its members, it has information that is sufficient to determine whether, under the valuation standards,[20] the compensation arrangement in its entirety is reasonable or the property transfer is at fair market value.[21]

(a) Knowledge and Expertise of Members

The phrase *given the knowledge and expertise of its members* has great significance. It often is overlooked in an assessment as to whether there is the

[18] See Chapter 3.
[19] Reg. § 53.4958-6(c)(1)(iii).
[20] See § 4.5.
[21] Reg. § 53.4958-6T(c)(2)(i).

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requisite appropriate data. That is, the competence of the board must be balanced against the quality and quantity of the data.

For example, the executive committee of the board of trustees of a university that is an applicable tax-exempt organization decided, as part of contract renewal negotiations, that the annual salary of its president should be $600,000. Although many members of the committee have significant business experience, none of them has any particular expertise in matters of compensation in the higher education setting. In reaching its decision, the committee relied solely on a national survey of compensation for university presidents that indicated these presidents receive annual compensation in the range of $100,000 to $700,000. This survey did not categorize its data by any criteria, such as the number of students served by the institution, annual revenues, academic ranking, or geographic location. Given the failure of the survey to provide information specific to universities comparable to this particular university, and because other information was not provided, the executive committee's decision with respect to the president's compensation was not based on appropriate data as to comparability.[22]

It should be noted that this conclusion does not necessarily mean that this president's compensation is now excessive. It means, rather, that the rebuttable presumption is not available.

The facts of this example can be varied somewhat. Suppose the national survey categorized the data regarding compensation for university presidents into segments based on various university-specific factors, such as the size of the institution (in terms of the number of its students and the amount of its revenues) and geographic location. The survey data show that university presidents at institutions comparable to and in the same geographic area as this particular university receive annual compensation in the range of $200,000 to $300,000. The committee relied on the survey data, along with its evaluation of the president's many years of service as a tenured professor and high-ranking university official at the university, in setting the president's annual compensation at $275,000. Now the data relied on by the executive committee constituted appropriate data as to comparability.[23]

It may be noted that this revision of the facts of the example shows that, in fact, the annual payment of $600,000 to this president would have been an excess benefit transaction.

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[22] Reg. § 53.4958-6(c)(2)(iv), Example 1.
[23] Reg. § 53.4958-6(c)(2)(iv), Example 2.

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(b) Relevant Information

In the case of compensation, relevant information includes but is not limited to:

- Compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions
- The availability of similar services in the geographic area of the applicable tax-exempt organization
- Current compensation surveys compiled by independent firms
- Actual written offers from similar institutions competing for the services of the disqualified person[24]

In the case of property, relevant information includes but is not limited to:

- Current independent appraisals of the value of all property to be transferred
- Offers received as part of an open and competitive bidding process[25]

While generally addressing the matters of compensation and property transfers, the tax regulations are silent on factors to review when the transaction entails the use of property, such as loans and rentals. In the case of loans, the factors to take into account include the amount of the loan, the rate of interest, the length of the lending period, whether there is security for the loan, and whether the loan is the subject of a note or other written instrument. In the case of rentals, the factors to review include the rental rate, the length of the rental period, and the type of property being rented. The reason for the transaction may be a factor in either situation.

If the amount involved is significant enough and if the organization can afford it, the ideal approach in this circumstance is to obtain a letter of opinion from an independent, competent consultant, with the report tailored to the particular facts involved.

As an illustration, the board of trustees of H, a hospital that is an applicable tax-exempt organization, is in the process of renewing the contracts of its chief executive officer and chief financial officer. Before doing so, the

[24] Reg. § 53.4958-6(c)(2)(i).
[25] *Id.*

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board commissioned a customized compensation survey from an independent firm that specializes in consulting on issues related to executive placement and compensation. The survey covered executives with comparable responsibilities at a significant number of taxable and tax-exempt hospitals. The survey data are sorted by a number of different variables, including the size of the hospitals and the nature of the services they provide, the level of experience and specific responsibilities of the executives, and the composition of the annual compensation packages. The board members were provided with the survey results, a detailed written analysis comparing the hospital's executives to those covered by the survey, and an opportunity to ask questions of a member of the firm that prepared the survey. This survey, as prepared and presented to H's board, constitutes appropriate data as to comparability.[26]

Assume the facts are the same as to this example, except that, one year later, H is negotiating a new contract with its chief executive officer. The governing board of H obtains information indicating that the relevant market conditions have not materially changed, and it does not possess any other information indicating that the results of the prior year's survey are no longer valid. Therefore, H may continue to rely on the independent compensation survey prepared for the prior year in setting annual compensation under the new contract.[27]

(c) Special Rules for Small Organizations

In the case of a small organization reviewing a compensation arrangement, the authorized body is considered to have appropriate data as to comparability if it has data on compensation paid by three comparable organizations in the same or similar communities for similar services. This is a safe-harbor rule. No inference is to be drawn, as to the collection of appropriate data, from circumstances that fall outside the safe harbor.[28]

For this purpose, a *small organization* is one with annual gross receipts (including contributions) of less than $1 million.[29] An organization may calculate its annual gross receipts on the basis of an average of its gross

[26] Reg. § 53.4958-6(c)((2)(iv), Example 3.
[27] *Id.*, Example 4.
[28] Reg. § 53.4958-6(c)(2)(ii).
[29] *Id.*

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receipts during its three prior tax years. If an applicable tax-exempt organization is controlled by or controls another entity,[30] however, the annual gross receipts of the organizations must be aggregated in making this calculation.[31]

As an example, T, a local repertory theater that is an applicable tax-exempt organization, has had annual gross receipts ranging from $400,000 to $800,000 over its past three tax years. In determining the next year's compensation for its artistic director, the board of directors of T relies on data compiled from a telephone survey of three unrelated repertory theaters of similar size in similar communities. A member of the board drafts a brief written summary of the annual compensation information obtained from this informal survey. The annual compensation information obtained in this telephone survey constitutes appropriate data as to comparability.[32]

§ 5.5 DOCUMENTATION

The third prong of the rebuttable presumption of reasonableness is that the authorized body adequately documented the basis for its determination concurrently with making the determination.

(a) General Rules

For a decision to be *adequately documented*, the written or electronic records of an authorized body must note:

- The terms of the transaction that was approved
- The date the transaction was approved
- The members of the authorized body who were present during the debate on the transaction that was approved and those who voted on it
- The comparability data obtained and relied on by the authorized body
- How this data was obtained

[30] See § 4.2.
[31] Reg. § 53,4958-6(c)(2)(iii).
[32] Reg. § 53.4958-6T(c)(2)(iv), Example 5.

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- Any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest[33] with respect to the transaction[34]

If an authorized body determines that reasonable compensation for a specific arrangement, or fair market value in a specific property transfer, is higher or lower than the range of comparability data obtained, the authorized body must record the basis for its determination.[35]

For a decision by an authorized body to be documented *concurrently*, records must be prepared before the later of the next meeting of the authorized body or 60 days after the final action or actions of the authorized body are taken. Records must be reviewed and approved by the authorized body as reasonable, accurate, and complete within a reasonable time thereafter.[36]

(b) Rules as to Fixed and Nonfixed Payments

In the case of fixed payments,[37] the rebuttable presumption of reasonableness applies to all payments made or transactions completed in accordance with a contract, provided that the three requirements of the presumption were met at the time the parties entered into the contract.[38] The exception is a special rule concerning nonfixed payments.

In general, in the case of a payment that is not a fixed payment, the rebuttable presumption of reasonableness arises only after:

- The exact amount of the payment is determined or a fixed formula[39] for calculating the payment is satisfied
- The three requirements for the presumption[40] subsequently are satisfied[41]

If, however, an authorized body approves an employment contract with a disqualified person that includes a nonfixed payment (e.g., a discretionary

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[33] See *supra* § 3.
[34] Reg. § 53-4958-6(c)(3)(i).
[35] Reg. § 53.4958-6(c)(3)(ii).
[36] *Id*.
[37] See § 4.4(b).
[38] Reg. § 53.4958-6(f).
[39] See § 4.4(b).
[40] See *supra* § 1.
[41] Reg. § 53.4958-6(d)(1).

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bonus) subject to a specified cap, the authorized body may establish a rebuttable presumption with respect to the nonfixed payment at the time the employment contract is entered into if:

- Prior to approving the contract, the authorized body obtains appropriate comparability data indicating that a fixed payment of up to a certain amount to the particular disqualified person would represent reasonable compensation
- The maximum amount payable under the contract, taking into account both fixed and nonfixed payments, does not exceed that certain amount referred to in the previous rule
- The other requirements for the rebuttable presumption are satisfied[42]

(c) Absence of Inference

The fact that a transaction between an applicable tax-exempt organization and a disqualified person does not qualify for the rebuttable presumption of reasonableness does not create any inference that the transaction is an excess benefit transaction. Likewise, nonqualification of a transaction does not exempt or relieve any person from compliance with any federal or state law imposing any obligation, duty, responsibility, or other standard of conduct with respect to the operation or administration of any applicable tax-exempt organization.[43]

§ 5.6 REBUTTING THE PRESUMPTION

The rules as to how the IRS may go about rebutting this presumption are a bit vague. This is not an absolute presumption; it is a rebuttable one.[44] Thus, even though the three requirements for the presumption are satisfied, the IRS still can rebut it.

The rule is that this rebuttal can occur only if the IRS develops sufficient contrary evidence to rebut the probative value of the comparability data relied on by the authorized body. With respect to a fixed payment, rebuttal evidence is limited to evidence relating to facts and circumstances existing

[42] Reg. § 53.4958-6(d)(2).
[43] Reg. § 53.4958-6(e).
[44] See *supra* § 1.

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on the date the parties enter into the contract pursuant to which the payment is made. This rule does not apply in the event of a substantial nonperformance. In all other circumstances—including nonfixed payments subject to a cap—rebuttal evidence may include facts and circumstances up to and including the date of payment.[45]

To date, there are no known instances of an IRS rebuttal of the presumption, either successful or unsuccessful. There is no court case or published IRS ruling. Of course, it is possible that an IRS rebuttal has occurred privately.

§ 5.7 IMPACT OF PRESUMPTION

The rebuttable presumption is having an impact on the structure and/or operations of applicable tax-exempt organizations and other tax-exempt organizations, in part because the elements of the rebuttable presumption reflect good operational practices and should be followed in any event. Some organizations are trying hard to comply with the requirements of the presumption. This effort can include a reorganization of the governing board—perhaps to the extreme of converting it from a captive board to an independent board—or creation of a qualifying committee.[46]

Obviously, another reason to pursue qualification under the presumption is to shift the burden of proving that a transaction embodies an excess benefit to the IRS. The hope here is that an auditing agent will become discouraged on learning that the three requirements have been complied with and move on to audit some other transaction.

An applicable tax-exempt organization, if it cannot satisfy all of the elements of the presumption, should make an effort to comply with as many of the elements as possible. As noted, the elements of the presumption reflect good management practices; thus every reasonable effort should be made to comply with as many of its requirements as is feasible. For example, an organization could have the appropriate data as to comparability and adequate documentation but have an authorized body that has individuals on it who have a conflict of interest. This effort should help the organiza-

[45] Reg. § 53.4958-6(b).

[46] As one commentator put the matter, "[o]rganizations are likely to attempt to qualify for the rebuttable presumption where that is feasible" (Faber II at 300).

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tion in the eyes of the IRS—it is better to try and fall short than to ignore the practices altogether.[47]

In any event, there may come a time when an applicable tax-exempt organization that was able to comply with the requirements of the presumption only partially is able to adhere to all of them.

[47] Again (see *supra* § 5(c)), there is no adverse inference created in the case of nonqualification under the presumption.

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