INTERNAL REVENUE SERVICE

200244028

TE/GE TECHNICAL ADVICE MEMORANDUM

JUN 21 2002

T:EO:B1

Area Manager, EO Examinations

Taxpayer's Name:

U/L: 501.00-00
4958.00-00

Taxpayer's Address:

Taxpayer's ID No.:

Years Involved:

Conferences Held:

LEGEND:

A =
B =
M =
N =
O =
x =

ISSUES:

1. With respect to M an organization described in section 501(c)(3) of the Internal Revenue Code, should B be classified as a disqualified person within the meaning of section 4958(f)(1)?

2. Did the Consulting Agreement constitute a written contract that was binding on September 13, 1995, within the meaning of section 53.4958-1(f)(2) of the Foundation and Similar Excise Tax Regulations?

3. If the Consulting Agreement constituted a written contract that was binding on September 13, 1995, was it materially changed by the Amended Consulting Agreement within the meaning of section 53.4958-1(f)(2) of the regulations?

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4. With regard to the compensation arrangement under the Amended Consulting Agreement, have the requirements under section 53.4958-6 of the regulations for establishing a rebuttable presumption been satisfied?

5. What is the appropriate method of measuring the value of the consideration B provided to M in return for the amounts M provided to B under the Amended Consulting Agreement?

6. Should any "excess benefit" analysis be based on the value of the combined services of B and A, B's spouse, relative to the combined consideration paid by M to A and B?

FACTS:

The Internal Revenue Service has recognized M as an organization described in section 501(c)(3) of the Code. M is the parent corporation of a number of organizations, providing them with administrative support. One of these subsidiaries is N, that is also recognized as an organization described in section 501(c)(3).

Employment Agreements

Effective February 25. M and A entered into an employment agreement for a term of five years (the ' Employment Agreement"). "). Under this agreement, A agreed to work full time as President and Chief Executive Officer of M.

Effective February 26, M and A entered into another employment agreement for a term of four years (the ' Employment Agreement"). Under this agreement, A agreed to work full time as President and Chief Executive Officer of M. The agreement provides that the term of employment is four years, subject to the right of A to extend the term for an additional year at his option, and subject to further extension upon mutual agreement of M and A.

Consulting Agreement

On February 26, A and B entered into a Consulting / Non-Competition Agreement with M (hereafter, the "Consulting Agreement"). The principal terms of this agreement were as follows:

A. Paragraph 1 of the agreement provides that it would become effective upon the expiration of the Employment Agreement.

B. Paragraph 3 provides that the consulting duties of A and B included:

- Representing M at meetings, activities and events;
- Using their contacts and relationships for the benefit of M;
- Participating in fundraising activities;
- Serving in a senior capacity on M's board of directors or on the foundation board;
- Consulting with management and with M's board of directors and consultants on specific projects; and,
- Undertaking specific projects.

C. Paragraph 4a provides that A's and B's obligation is "to work no more than half a normal work schedule." In addition, their obligation to devote half of their time will be reduced proportionately as their compensation declines.

D. Paragraph 5 provides that A and B are entitled to the same health benefits to which they were entitled when A was Chief Executive Officer of M, less benefits received from Medicare. The right to such benefits will continue after termination of this agreement until the death of the survivor. M will pay A and B the taxes they owe in connection with this health coverage.

E. Paragraph 6 states that the term of the agreement is five years.

F. Paragraph 7 provides that the annual compensation to be paid to A and B collectively, or to the survivor individually, for the consulting services will be 60x for each of the first three years and 55x for each of the last two years. This compensation, payable monthly, will be divided between A (60 percent) and B (40 percent).

G. Paragraph 8 provides that the agreement also includes a covenant not to compete covering the same term as the consulting part of the agreement. Under this provision, A and B will not engage in any activity that directly or

indirectly competes with M or its subsidiaries, will not directly or indirectly divert any business of M or its subsidiaries to any competitor, and will not induce any employee of M or its subsidiaries to leave his or her employment.

H. Paragraph 8.4 provides that the payment for the covenant not to compete is a lump sum of 40x, which is in addition to the amounts payable for consulting services.

I. Paragraph 9 provides that A and B are required to keep confidential all valuable information relating to M's business.

Before the expiration of the Employment Agreement, A stated that he gave M written notice extending the term of the Employment Agreement for one year, i.e., from February 25, , to February 25, . (A has been unable to locate a copy of this letter.) In a letter dated January 23 , A and M agreed to extend the term of the Employment Agreement for one year, i.e., from February 26, until February 25, . However, on March 26 , A gave written notice to M that he would terminate his employment under the extended Employment Agreement, effective April 30, .

Personnel Committee

On November 20, , M's Board of Directors went into Executive Session to discuss executive compensation matters. At this meeting, the Chairman explained that Q, an executive compensation firm, was hired to evaluate M's compensation package in comparison to other state and national nonprofit health care institutions. Q prepared a report entitled "Chief Executive Officer Compensation Analysis and Recommendations," which was dated Novembe

The Personnel Committee of M is an authorized executive committee established by M's Board of Directors consisting of five members. On November 20, , the Personnel Committee, held a meeting at which it relied on data provided by Q, to establish that the amounts payable under the Consulting Agreement were reasonable. This was documented in minutes of M's Board of Directors dated November 20 .

On April 4 , the Personnel Committee held a meeting at which three of its five members were present. At this meeting, among other matters, the Personnel Committee considered the Amended Consulting Agreement (described below). These

proceedings were recorded in the Personnel Committee's written minutes. The April 4, minutes do not refer to the November compensation report by Q.

On April 19, , the Personnel Committee held a meeting at which three of its five members were present. At this meeting, among other matters, the Personnel Committee approved the Amended Consulting Agreement (as described below), and instructed the committee chairman to sign these documents on behalf of M. These proceedings were recorded in the Personnel Committee's written minutes.

None of the members of the Personnel Committee who were present at the April 4 and 19, meetings either directly or indirectly benefited from the agreements approved; none was in an employment relationship with A or B or subject to either one's direction or control; none received compensation or other payments subject to either one's approval; and none approved the agreements because A or B had approved a transaction providing economic benefits to the member.

Amended Consulting Agreement

On April 19 , A and B entered into an agreement with M amending the Consulting Agreement (the "Amended Consulting Agreement"). The Amended Consulting Agreement states that it is "an amendment and restatement of an agreement entered into as of February 26 ." The principal terms of the Amended Consulting Agreement are as follows:

A. Paragraph 1 of the agreement provides that the effective date is May 1,

B. Paragraph 3 provides that A's and B's consulting duties include:

- Representing M at meetings, activities and events;
- Using their contacts and relationships for the benefit of M;
- Participating in fundraising activities;
- Serving in a senior capacity on M's boards of directors or on the foundation board;
- Consulting with management and with M's board of directors and consultants on specific projects; and

- Rendering advice and support to M with respect to projects worked on by A during his tenure as CEO of M.

C. Paragraph 4a provides that A and B agreed "to work no more than one quarter of a normal work schedule." In addition, their obligation to devote one quarter of their time will be reduced proportionately as their compensation declines.

D. Paragraph 5 provides that A and B are entitled to health benefits comparable to that which they were entitled when A was Chief Executive Officer of M, less any benefits that are received under Medicare. The level of health benefits will be commensurate with that of a Chief Executive Officer of a major health care system. These benefits will continue after the end of this agreement, until the death of both A and B. In addition, M would pay A and B any taxes relating to the additional taxable income that results from the receipt of these benefits.

E. Paragraph 6 provides that the term of the agreement is five years.

F. Paragraph 7 provides that the annual compensation to be paid to A and B collectively, or to the survivor individually, for the consulting services and for the covenant not to compete is 50x for each of the first three years and 40x for each of the last two years. This compensation, payable monthly, will be divided between A (60 percent) and B (40 percent). If either A or B is unable to provide services due to disability, payments will continue uninterrupted to B and B. If either A or B were to die during the term of this agreement, 100% of the unreduced total payments would be allocated to the survivor.

G. Paragraph 8 provides that the agreement also includes a covenant not to compete covering the same term as the consulting part of the agreement. Under this provision, A and B will not engage in any activity that directly or indirectly competes with M or its subsidiaries, and will not directly or indirectly divert any business of M or its subsidiaries to any competitor, and will not induce any employee of M or its subsidiaries to leave his or her employment.

H. Paragraph 8.4 provides that the payment for the covenant not to compete is included in the payments for consulting services.

I. Paragraph 9 provides that A and B are required to keep confidential all valuable information relating to M's business.

J. Paragraph 10 provides that if N sells all or a substantial portion of its operating assets, such that M's assets are reduced to a level that provides, in A's and B's opinion, inadequate security of future income for the performance of this agreement, M will either pre-fund the agreement by payment to a trust for the benefit of A and B, or purchase, by lump sum payment, an annuity for their benefit to provide the payments.

APPLICABLE LAW:

Section 4958 was added to the Internal Revenue Code by section 1311 of the Taxpayer Bill of Rights 2, P.L. 104-168, 110 Stat. 1452, enacted July 30, 1996. The section 4958 excise taxes generally apply to excess benefit transactions occurring on or after September 14, 1995. The Report from the Committee on Ways and Means on the Taxpayer Bill of Rights 2, H.R. 2337, was submitted March 28, 1996. H. Rep. No. 506, 104th Cong., 2d Sess. (1996) 53. Proposed regulations were published in the Federal Register August 4, 1998, 63 F.R. 41486. The proposed regulations were replaced by temporary regulations that were published in the Federal Register January 10, 2001, 66 F.R. 2173. The temporary regulations were replaced by final regulations that were published in the Federal Register January 23, 2002, 67 F.R. 3076. The final regulations were effective January 23, 2002 and apply as of that date.

Section 4958(a)(1) of the Code imposes on each excess benefit transaction a tax equal to 25 percent of the excess benefit (the "first tier tax"). This tax must be paid by any disqualified person with respect to such transaction.

Section 4958(b) of the Code provides that where an initial tax is imposed, but the excess benefit involved in such transaction is not corrected within the taxable period, a tax equal to 200 percent of the excess benefit involved is imposed and must be paid by any disqualified person with respect to such transaction (the "second tier tax").

Section 4958(c) of the Code, in part, defines "excess benefit transaction" as any transaction in which an economic benefit is provided by an "applicable tax-exempt organization" directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

Section 4958(e) of the Code defines "applicable tax-exempt organization" as an organization described in either section 501(c)(3) or section 501(c)(4) of the Code or an organization which was so described at any time during the five-year period ending on the date of the excess benefit transaction.

Section 4958(f)(1) of the Code defines "disqualified person" as (A) any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization, (B) a member of the family of a disqualified person, and (C) a 35-percent controlled entity.

Section 53.4958-1(e)(1) of the regulations provides that except as otherwise provided, an excess benefit transaction occurs on the date on which the disqualified person receives the economic benefit for federal income tax purposes. Section 53.4958-1(e)(2) provides that in the case of rights to future compensation, including benefits under a nonqualified deferred compensation plan, the excess benefit transaction occurs on the date the right to future compensation is not subject to a substantial risk of forfeiture. However, where a disqualified person elects under section 83(b) of the Code to include deferred compensation in gross income in a taxable year, any excess benefit transaction with respect to this deferred compensation occurs in that year.

Section 53.4958-1(f)(1) of the regulations provides that section 4958 of the Code applies to transactions occurring on or after September 14, 1995. However, under section 53.4958-1(f)(2), section 4958 does not apply to any transaction occurring pursuant to a written contract that was binding on September 13, 1995, and at all times thereafter before the transaction occurs. But if a binding written contract is materially changed, it is treated as a new contract entered into as of the date the material change is effective. The regulations state: "A material change includes an extension or renewal of the contract . . ., or a more than incidental change to any payment under the contract." The extension or renewal of a contract that results from the contracting person unilaterally exercising an option expressly granted by the contract is not a material change.

Section 53.4958-3(a)(1) of the regulations defines a disqualified person, with respect to any transaction, as any person who was in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization at any time during the five-year period ending on the date of the transaction.

Section 53.4958-3(b)(1) of the regulations provides that a person is a disqualified person with respect to any transaction with an applicable tax-exempt organization if the person is a member of the family of a person who is a disqualified person with respect

to any transaction with the same organization. A person's family includes the person's spouse.

Section 53.4958-3(c) of the regulations provides that voting members of the governing body, presidents, chief executive officers, or chief operating officers are persons who are in a position to exercise substantial influence over the affairs of the organization.

Section 53.4958-4(a)(1) of the regulations provides that to determine whether an excess benefit transaction has occurred, all consideration and benefits exchanged between a disqualified person and the applicable tax-exempt organization and all entities it controls are taken into account.

Section 53.4958-4(a)(3)(ii)(A) provides that the term "fixed payment" means an amount of cash or other property specified in the contract, or determined by a fixed formula specified in the contract, which is to be paid or transferred in exchange for the provision of specified services or property. A fixed formula may incorporate an amount that depends upon future specified events or contingencies, provided that no person exercises discretion when calculating the amount of a payment or deciding whether to make a payment (such as a bonus). Section 53.4958-4(a)(3)(v) provides that if the parties make a material change to a contract, it is treated as a new contract as of the date the material change is effective. The regulations state, "A material change includes an extension or renewal of the contract . . . , or a more than incidental change to any amount payable under the contract." The extension or renewal of a contract that results from the contracting person unilaterally exercising an option expressly granted by the contract is not a material change.

Section 53.4958-4(b)(1)(ii)(A) of the regulations provides that the value of services is the amount that would ordinarily be paid for like services by like enterprises under like circumstances (i.e., reasonable compensation). The standards under section 162 of the Code apply in determining the reasonableness of compensation, taking into account the aggregate benefits provided to a person and the rate at which any deferred compensation accrues. Section 53.4958-4(b)(1)(ii)(B) of the regulations provides that the compensation for purposes of determining reasonableness under section 4958 includes all economic benefits provided by the organization in exchange for the performance of services, except for economic benefits that are disregarded for purposes of section 4958 under section 53.4958-4(a)(4).

Section 53.4958-4(b)(2) of the regulations provides that the facts and circumstances to be taken into consideration in determining the reasonableness of a fixed payment are those existing on the date the parties enter into the contract pursuant to which the payment is made.

Section 53.4958-6(a) of the regulations provides that payments under a compensation arrangement are presumed to be reasonable if all of the requirements in section 53.4958-6(c) are satisfied, as follows:

1. The compensation arrangement is approved in advance by an authorized body of the organization or an entity it controls, composed entirely of individuals who do not have a conflict of interest as to the compensation arrangement or property transfer;

2. Prior to making its determination, the authorized body obtained and relied upon appropriate data as to comparability; and

3. The authorized body adequately documented the basis for its determination concurrently with making that determination.

Section 53.4958-6(e) of the regulations provides that the fact that a transaction between an organization and a disqualified person is not subject to the rebuttable presumption of reasonableness does not create any inference that the transaction is an excess benefit transaction.

ANALYSIS:

Section 4958 of the Code was enacted July 30, 1996, but generally applies to excess benefit transactions occurring on or after September 14, 1995. The final regulations, which apply as of January 23, 2002, represent a fair and reasonable interpretation of section 4958, based on the intent of Congress as expressed in the Report from the Committee on Ways and Means submitted March 30, 1996. H. Rep. No. 506, 104th Cong., 2d Sess. (1996) 53.

Issue 1

With respect to M, an organization described in section 501(c)(3) of the Code, should B be classified as a disqualified person within the meaning of section 4958(f)(1)?

Section 4958(f)(1) of the Code defines "disqualified person" as including any person who was, at any time during the five-year period ending on the date of a transaction, in a position to exercise substantial influence over the affairs of the organization. See also section 53.4958-3(a)(1) of the regulations.

Section 53.4958-3(c) of the regulations provides that voting members of the governing body, presidents, chief executive officers, or chief operating officers are persons who are in a position to exercise substantial influence over the affairs of the organization.

Under the Employment Agreement and the Employment Agreement M employed A as its President and Chief Executive Officer. In this capacity, A was the most senior officer of the organization responsible for its day-to-day operations. In addition, A served as a member of the board of directors of M. Thus, A was continuously employed in this capacity by M from February 25, , through April 30, , the effective date of A's resignation. Accordingly, during this period, A had sufficient authority over M so that he was in a position to exercise substantial influence over its affairs.

Therefore, on April 30, , and for the five-year period preceding that date, with respect to M, an organization described in section 501(c)(3) of the Code, A was a disqualified person within the meaning of section 4958(f)(1).

Section 53.4958-3(b)(1) of the regulations provides that a person is a disqualified person with respect to any transaction with an applicable tax-exempt organization if the person is the spouse of a person who is a disqualified person with respect to any transaction with the same organization. Since A is a disqualified person with respect to M, and B is the spouse of A, B is also a disqualified person with respect to M.

Issue 2

Did the Consulting Agreement constitute a written contract that was binding on September 13, 1995, under section 53.4958-1(f)(2) of the regulations?

Effective February 26 A and B, and M entered into the Consulting Agreement, a written agreement which, presumably, was enforceable under applicable state law. This agreement was to take effect upon the expiration of the Employment Agreement, which had an original expiration date of February 25

However, prior to this date, pursuant to a unilateral option expressly granted by the Employment Agreement, A extended the expiration date of the Employment Agreement by one year, until February 25 This had the effect of extending the effective date of the Consulting Agreement until February 25

Therefore, since performance under the Consulting Agreement would not begin until the expiration of the Employment Agreement and A properly extended this agreement, on September 13, , the Consulting Agreement constituted a written contract that was binding under section 53.4958-1(f)(2) of the regulations.

Issue 3

If the Consulting Agreement constituted a written contract that was binding on September 13, 1995, was it materially changed by the Amended Consulting Agreement within the meaning of section 53.4958-1(f)(2) of the regulations?

The Amended Consulting Agreement was executed as a separate agreement between A and B and M and was effective May 1, . The express purpose of the Amended Consulting Agreement was to amend the Consulting Agreement. Under the Amended Consulting Agreement, A and B would perform various consulting services for M on a quarter-time basis. The term of the agreement was five years. In addition, during the term of the agreement, A and B would comply with a covenant not to compete. In return for the consulting services and for the covenant not to compete, M would pay A and B a specified amount of annual compensation. If either A or B were unable to perform their duties, the payments specified in the contract would continue. In addition, upon the death of either A or B, M would continue to make payments to the survivor.

Thus, the Amended Consulting Agreement made several substantial changes to the Consulting Agreement, including:

- Extending the effective date to May 1
- Reducing the time A and B would work from half time to quarter time and reducing their annual compensation accordingly.
- Changing the compensation structure from annual compensation for consulting services plus an additional lump sum for the covenant not to compete, to an annual amount that included compensation for both the consulting services and the covenant not to compete.
- Adding a new payment provision that in the event of the death of either B or B during the term of the contract, M would continue making the same annual payments to the survivor for the remaining term of the contract,

without any reduction for the portion that was previously allocated to the decedent.

- Adding a provision stating that if N sells all or a substantial portion of its operating assets, so that A and B believe that there is inadequate security of future income for the performance of this agreement, M will either pre-fund the agreement by payment to a trust for the benefit of A and B, or purchase, by lump sum payment, an annuity for their benefit to provide the payments.

Based on the foregoing analysis, pursuant to section 53.4958-1(f)(2) of the regulations, the Amended Consulting Agreement made material changes to the Consulting Agreement. Under section 53.4958-1(f)(2), if a binding written contract is materially changed, it is treated as a new contract entered into as of the date the material change is effective. As a result of the material changes the Amended Consulting Agreement made to the Consulting Agreement, the Amended Consulting Agreement is a new contract that was effective May 1,

Issue 4

With regard to the compensation arrangement under the Amended Consulting Agreement, have the requirements under section 53.4958-6 of the regulations for establishing a rebuttable presumption been satisfied?

Section 53.4958-6 of the regulations provides that payments under a compensation arrangement are presumed to be reasonable if several conditions are satisfied.

First, the compensation arrangement must be approved in advance by an authorized body of the organization, composed entirely of individuals who do not have a conflict of interest as to the compensation arrangement.

Authorized Body. Section 53.4958-6(c)(1)(i)(B) of the regulations provides that an authorized body includes a committee of the governing body, which may be composed of any individuals who are permitted under state law to serve on such committee, to the extent that the committee is permitted by state law to act on behalf of the governing body. Since M's Personnel Committee is an authorized executive committee of M established by M's Board of Directors, it is an authorized body within the meaning of section 53.4958-6(c)(1).

Approved in Advance. M's Personnel Committee, at its meetings on April 4 and 19, 1996, considered and approved the Amended Consulting Agreement dated April 19, 1996. Therefore, an authorized body of M approved the compensation arrangement with A and B in advance, within the meaning of section 53.4958-6(a)(1) of the regulations.

Conflict of Interest. Section 53.4958-6(c)(1)(iii) of the regulations provides that a member of the authorized body does not have a conflict of interest with respect to a compensation arrangement if the member:

- Is not a disqualified person participating in or economically benefiting from the compensation arrangement and is not a member of the family of such disqualified person;
- 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;
- Does not receive compensation or other payments subject to approval by any disqualified person participating in or economically benefiting from the compensation arrangement;
- Has no material financial interest affected by the compensation arrangement; and
- Does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement who in turn has approved or will approve a transaction providing economic benefits to the member.

None of the members of the Personnel Committee who were present at the meetings of April 4 and 19 either directly or indirectly benefited from the agreements approved; none was in an employment relationship with A or B or was subject to either one's direction or control; none received compensation or other payments subject to A's or B's approval; and none approved the agreements because A or B had approved a transaction providing economic benefits to such member. Therefore, none of the members of M's Personnel Committee had a conflict of interest with respect to the compensation arrangement with A or B involving the Amended Consulting Agreement within the meaning of section 53.4958-6(c)(1)(iii) of the regulations.

Second, prior to making its determination, the authorized body must have obtained and relied upon appropriate data as to comparability. Section 53.4958-6(c)(2)(i) of the regulations states:

> An authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether, under the standards set forth in § 53.4958-4(b) [relating to reasonable compensation], the compensation arrangement in its entirety is reasonable. . . . 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; and actual written offers from similar institutions competing for the services of the disqualified person.

There is no evidence that any of the members of M's Personnel Committee who approved the Amended Consulting Agreement had particular knowledge or expertise in determining whether compensation paid to the chief executive officer of a large hospital system was reasonable.

The April 4, minutes did not state that M's Personnel Committee considered any compensation analysis in making its decision to approve the Amended Consulting Agreement. Nor do the minutes refer to the Novembe compensation report by Q. In any event, since the November report by Q was issued some nine months after the February 26, effective date of the Consulting Agreement, M's Board of Directors could not have considered this report in approving the Consulting Agreement. Furthermore, even if, on April 4, M's Personnel Committee considered the Novembe report by Q when it approved the Amended Consulting Agreement, this report was not meaningful since it was almost five years old.

According to the minutes of April 4 and 19 M's Personnel Committee did not address whether the payments under the Amended Consulting Agreement would constitute reasonable compensation to B in relation to the services she would perform for M. Based on the April 4 minutes, M's Personnel Committee did not consider, for example, compensation levels paid by similarly situated organizations, the availability of similar services in M's geographic area, compensation surveys compiled by independent firms or actual written offers from similar institutions competing for A' or

B's services. Therefore, M's Personnel Committee did not satisfy the comparability requirement of section 53.4958-6(c)(2)(i) of the regulations.

Third, the authorized body must adequately document the basis for its determination concurrently with making that determination. Section. 53.4958-6(c)(3)(i) of the regulations provides that for a decision to be documented adequately the records of the authorized body must note:

(A) The terms of the transaction that was approved and the date it was approved;

(B) The members of the authorized body who were present during debate on the transaction that was approved and those who voted on it;

(C) The comparability data obtained and relied upon by the authorized body and how the data was obtained; and

(D) 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 with respect to the transaction.

The Personnel Committee's written minutes, which recorded the proceedings of its meetings on April 4 and 19, during which the Committee approved the Amended Consulting Agreement, satisfy the requirements for adequate documentation within the meaning of section 53.4958-6(c)(3)(i) of the regulations.

Based on all the available information, we believe that the first and third requirements contained in section 53.4958-6 of the regulations have been met, while the second requirement has not been met. Since all three conditions for establishing a rebuttable presumption must be satisfied, the failure to consider appropriate comparability data as noted above precludes our finding that all three requirements have been met. Thus, in this instance, B has not demonstrated compliance with all of the requirements for establishing the rebuttable presumption.

Issue 5

What is the appropriate method of measuring the value of the consideration B provided to M in return for M's payments to B under the Amended Consulting Agreement?

Under the Amended Consulting Agreement, beginning May 1, A and B agreed to devote 25 percent of their time performing various services for M for a period of five years. In addition, during this five-year period, A and B would neither engage in any competing activities, divert any M business to any competitor, nor induce any of M's employees to leave his or her employment. (Hereafter, these restrictions are collectively referred to as a "Non-Compete Covenant.")

In return for the services performed and the Non-Compete Covenant, M agreed to pay A and B 50x in each of the first three years and 40x in each of the last two years. (Hereafter, these payments are referred to as "Consulting Fees.") Sixty percent of the Consulting Fees are allocated to A and 40 percent are allocated to B. If either A or B becomes disabled and is unable to perform the contracted services, all of the Consulting Fees would nevertheless continue. If either A or B died during the term of this agreement, all of the Consulting Fees would be allocated to the survivor. In addition, M agreed to provide A and B with health benefits comparable to those of a chief executive officer of a major health system and to reimburse A and B for the income taxes that result from the receipt of these health benefits. These benefits will continue beyond the end of the agreement, until the death of both A and B. Finally, if N sells all or a substantial portion of its operating assets, so that in the opinion of A and B, there is inadequate security for the payment of the Consulting Fees, M would either pre-fund the agreement by payment to a trust, or purchase an annuity for the benefit of A and B.

The Consulting Fees were fixed payments within the meaning of section 53.4958-4(a)(3)(ii)(A) of the regulations. Therefore, under section 53.4958-4(b)(2), the facts and circumstances to be taken into consideration in determining the reasonableness of the Consulting Fees are those existing on April 19, , the date the parties entered into the Amended Consulting Agreement, the contract pursuant to which the Consulting Fees were paid. The facts and circumstances that should be considered in determining the reasonableness of the Consulting Fees include, among others:

- There is no information relating to B's education, employment or work experience or specific knowledge or expertise in the health care industry in relation to the services that she agreed to perform for M.

- B would work only 25 percent of his time, so that the likelihood of her competing with M, and thus the value of the Non-Compete Covenant, would be less than if she were performing services on a full-time basis.

- Since there is no information relating to B's education, employment or work experience or specific knowledge or expertise in the health care industry in relation to the services that she agreed to perform for M, the value of the Non-Compete Covenant should be considered in this context.

- B would continue to receive Consulting Fees even if she were disabled and unable to perform the contracted services.

- Even though 60 percent of the Consulting Fees were allocated to A, if A died during the term of the agreement, B would receive 100 percent of the Consulting Fees.

- B would receive health benefits comparable to those that would be received by the spouse of a chief executive officer of a major health care system.

- B would receive a reimbursement of income taxes relating to additional taxable income resulting from the receipt of these health benefits.

- Even after the end of the Amended Consulting Agreement, B would continue to receive these health benefits for life.

Under section 53.4958-4(b)(1)(ii)(A) of the regulations, the value of the services B provided to M, including the value of the Non-Compete Covenant, over the five-year term of the Amended Consulting Agreement is the amount that would ordinarily be paid for like services by like enterprises under like circumstances using the standards under section 162 of the Code.

Therefore, under section 53.4958-4(b)(1)(ii)(B) of the regulations, in determining whether any of the compensation B received from M in each year under the Amended Consulting Agreement was reasonable compensation, the value of the services B performed for M each year of the agreement and the value of the Non-Compete Covenant during the same year should be compared with the value of the total economic benefits M provided to B during the same year under the Amended Consulting Agreement. The total economic benefits to be considered for each year include the present value of the health care benefits, including the taxes on these benefits, which B would likely receive over her expected life span.

If the value of the total economic benefits B received in each year during the term of the Amended Consulting Agreement was equal to or less than the value of the

services B performed for M during each year, none of the Consulting Fees B received would constitute an excess benefit transaction under section 4958(c)(1) of the Code.

However, if the value of the total economic benefits B received in each year during the term of the Amended Consulting Agreement exceeded the value of the services B performed for M during the same year and the value of the Non-Compete Covenant, this excess would constitute an excess benefit transaction in the year received under section 4958(c)(1) of the Code.

Issue 6

Should any "excess benefit" analysis be based on the value of the combined services of A and B, A's spouse, relative to the combined consideration paid by M to A and B?

Section 4958 of the Code imposes certain excise taxes on excess benefit transactions between disqualified persons and applicable tax-exempt organizations. Section 53.4958-3(a)(1) of the regulations defines the term "disqualified person," with respect to any transaction, as any person who was in a position to exercise substantial influence over the affairs of an applicable tax-exempt organization at any time during the five-year period ending on the date of the transaction.

The excise taxes imposed by section 4958 of the Code apply to each excess benefit transaction between a disqualified person and an applicable tax-exempt organization. An excess benefit is defined as the amount by which the value of the economic benefit provided by an applicable tax-exempt organization, directly or indirectly, to or for the use of any disqualified person exceeds the value of the consideration (including the performance of services) received for providing such benefits. See sections 53.4958-1(b) and 53.4958-4(a)(1) of the regulations.

The taxes imposed under section 4958 of the Code are payable by any disqualified person who received an excess benefit from a particular excess benefit transaction. In addition, with respect to any excess benefit transaction, if more than one disqualified person is liable for any of the section 4958 excise taxes, all such persons are jointly and severally liable for that tax. See section 53.4958-1(c) of the regulations. A person is treated as a disqualified person by virtue of being a member of the family of someone who is already a disqualified person. See section 53.4958-3(b)(1).

Section 4958 of the Code applies to each excess benefit received by each disqualified person pursuant to each excess benefit transaction between that disqualified person and an applicable tax-exempt organization. Under the regulations, a member of a disqualified person's family is also treated as a disqualified person. In addition, if more than one disqualified person receives an excess benefit from the same excess benefit transaction, all the disqualified persons are jointly and severally liable for the appropriate excise tax. Nothing in the statute, regulations or legislative history of section 4958 provides any authority for measuring either the value of the benefits received or the value of the services provided by reference to more than one disqualified person, whether husband and wife or otherwise. Thus, even if two disqualified persons are expected to provide services together, whether or not they are spouses, each disqualified person is treated as a separate taxpayer for purposes of section 4958. Therefore, even where two or more disqualified persons perform services as a team, in determining whether these disqualified persons received any excess benefits in any particular year, the total value of each disqualified person's services provided to the applicable tax-exempt organization in that year must be compared with the value of the benefits received by that particular disqualified person for that year.

In determining whether B received any excess benefit from the compensation she received from M, the value of the services B alone provided to M must be compared with the amount of the compensation from M that was allocated to B alone, even though M expected that A and B would be providing services as a team.

In support of its position, B cited Lewisville Investment Company, Inc., Idaho Fresh Pak, Inc. v. Commissioner, et al., 56 T.C. 770 (1971), nonacq. 1976-2 C.B. 3. In this case, the issue was whether the compensation paid to two groups of brothers as a unit was deductible as reasonable compensation under section 162 of the Code. The agreement with the brothers did not specify the service to be performed by particular individuals. Instead, it treated each group of brothers as a unit, leaving to them the decision as to which ones would perform the services required and how they would share the compensation paid to their respective units. The Tax Court, in concluding that the reasonableness of compensation should be determined based on the total value of the services performed by each unit, not by each individual, stated:

> We are not here concerned with how that compensation should be taxed in the hands of the members of each unit, but whether the total amount paid to each unit was reasonable. The situation is analogous to a joint venture providing management services for a corporation on a commission basis; in those circumstances the issue would be whether the

> total compensation paid for the services actually rendered was reasonable, not whether each member of the joint venture earned as much thereof as was allocated to him.

56 T.C. at 783.

However, IRS Chief Counsel, in the Action on Decision relating to this case, stated:

> The decision of the Court is technically incorrect. Since the Court did not find that the payments were made to an entity distinct from the individuals involved, it should have measured the reasonableness of the compensation paid in light of the services actually rendered by each individual. However, the Court did indicate that the total compensation paid was warranted considering the total services actually rendered. Since this finding can be supported by the record, no appeal was taken. However in future income splitting cases involving this issue, consideration should be given to determining whether the services were rendered by the individuals as employees of the corporation or by the joint venture and also whether statutory notices should be issued as well to the recipients of the income. In this manner the interest of the Government will be fully protected.

1975 AOD Lexis 51.

Section 4958 of the Code establishes an excise tax on excess benefit transactions between a disqualified person and an applicable tax-exempt organization. The tax is payable by the disqualified person. In the case of compensation paid to a disqualified person, to determine whether any portion of the compensation constituted an excess benefit, and whether the disqualified person was liable for any section 4958 tax, it is necessary to compare the value of the compensation paid to each disqualified person with the value of the services which that particular disqualified person provided to the organization. See sections 53.4958-1(b) and 53.4958-4(b)(1) of the regulations.

Therefore, even though A and B were ostensibly performing consulting services for M as a single unit, for purposes of section 4958 of the Code, since A and B are each separate disqualified persons with respect to M, to determine whether any portion of their compensation constituted an excess benefit, it is necessary to determine the value of the services performed by each person, not the value of the services they performed as a unit.

A copy of this memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

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