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Mr. Louis E. Slovensky
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Dear Louis:

Per your request, we have outlined the tax rules for intermediate sanctions, employee business expenses, accountable and nonaccountable plans (including substantiation requirements), club dues, meals and entertainment, travel expenses, fringe benefits, employee gifts and achievement awards, and political expenditures (including lobbying and political campaign activities).

Intermediate Sanctions

Intermediate Sanctions were passed under the Taxpayer Bill of Rights 2 in 1995 on certain "excess benefit transactions" between disqualified persons and public charities and social welfare organizations (Internal Revenue Code ("IRC") § 501(c)(3) and 501(c)(4)). These rules were passed to give the Internal Revenue Service a lesser, but more practical, penalty provision than the existing sanction which provides only revocation of the organization's exempt status.

The IRC introduces and proposed regulations elaborate on various terms under section 4958 (e.g., organization manager, disqualified person, excess benefit transaction, applicable tax-exempt organization, documentation and correction). More importantly, the proposed regulations address the determination of whether compensation is reasonable, and specify requirements for triggering a rebuttable presumption of reasonableness.

A prohibited excess benefit transaction between a disqualified person and a public charity or social welfare organization will result in a 25% excise tax sanction on the disqualified person and a 10% sanction on an organization manager that participated in and had knowledge of the transaction. A 200% excise tax sanction is imposed on the disqualified person where the transaction is not corrected. The taxes are imposed on the amount of excess benefit the disqualified person receives as a result of the transaction. Generally, this is the amount over what is determined as reasonable compensation or the economic benefit received in excess of fair market value.

Organization manager

Each organization manager, who participated in an excess benefit transaction, knowing that it was such a transaction, is subject to excise taxes unless such participation was not willful and was due to reasonable cause.

An organization manager is any officer, director, or trustee of an applicable tax-exempt organization, or any individual having powers or responsibilities similar to those of officers, directors, or trustees.

Disqualified person

In general, a disqualified person is a person who, with respect to any transaction with an applicable tax-exempt organization, was in a position to exercise substantial influence over the affairs of the organization.

The proposed regulations specifically identify certain persons as having substantial influence over the affairs of an applicable tax-exempt organization, including governing board voting members; the president, CEO, or COO; the treasurer or CFO, and other officers with substantial influence. The proposed regulations deem two categories of persons not to have substantial influence over the affairs of an applicable tax-exempt organization -- other Section 501(c)(3) public charities and certain non-highly compensated employees (in general, those receiving less than $80,000 per year in compensation).

Except as specified by statute or regulations, **the determination of whether a person has substantial influence over the affairs of an organization would be based on all relevant facts and circumstances**. A person who has managerial control over a discrete segment of an organization may nonetheless be in a position to exercise substantial influence over the affairs of the entire organization. Examples in the proposed regulations describe certain facts and circumstances which would indicate whether an individual is a disqualified person.

Excess benefit transaction

An excess benefit transaction is any transaction in which an economic benefit is provided **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. A benefit can be provided indirectly if it is provided through one or more entities controlled by or affiliated with the applicable tax-exempt organization. Compensation is one of the most common transactions that may result in an excess benefit transaction and is therefore examined based on whether a compensation package is reasonable.

Compensation

Compensation for the performance of services is reasonable only if it is an amount that would ordinarily be paid for like services by like enterprises under like circumstances. Examples in the proposed regulations illustrate whether reasonableness can be determined based on circumstances existing at the time a contract for the performance of services was made. Compensation includes certain deferred compensation and taxable and non-taxable fringe benefits.

An economic benefit provided to or for a disqualified person is not treated as consideration for the performance of services -- and thus cannot constitute reasonable compensation -- unless the organization clearly indicates its intent to treat the benefit as compensation when paid. Under the proposed regulations, the required intent must be shown by clear and convincing evidence of having that intent when the benefit was paid (i.e. reporting on Form W-2, 1099, etc.).

Revenue-sharing arrangements

The proposed regulations apply a facts and circumstances test to assess whether a transaction in which the amount of an economic benefit provided to or for a disqualified person is determined in whole or in part by the revenues of one or more activities of the applicable tax-exempt organization results in inurement, and therefore constitutes an excess benefit transaction. This provision primarily addresses joint ventures between an organization and a disqualified person.

Rebuttable presumption of reasonable compensation

The proposed regulations provide that a compensation arrangement with a disqualified person is presumed to be reasonable, and a transfer of property, a right to use property, or any other benefit or privilege between the organization and a disqualified person is presumed to be at fair market value, if three conditions are satisfied:

- the compensation arrangement or terms of transfer are approved by the organization's governing body or a committee thereof composed entirely of individuals who do not have a conflict of interest with respect to the arrangement or transaction;

- the governing body or committee relied upon appropriate data as to comparability prior to making its determination; and

- the governing body or committee adequately documented the basis for its determination concurrently with making that determination.

The UAB Educational Foundation should review transactions to ensure that there is adequate documentation to substantiate such transactions and that contracts are entered into for fair value.

Employee Business Expenses

In examining the rules surrounding certain employee business expenses and reimbursements, we must first look at the rules of deductibility for taxable organizations as the same rules apply to employees of tax-exempt entities.

Generally, a taxpayer may deduct expenses incurred in a trade or business from gross income. It has been recognized that the performance of services as an employee constitutes the carrying on of a trade or business, and therefore, the employee can deduct the ordinary and necessary expenses that he or she may incur. Expenses may be deducted only if they qualify as business expenses. In order to qualify as a business expense, the expense must be incurred in carrying on a trade or business and the expense must be ordinary and necessary. An "ordinary" expense is one that is common or usual within the taxpayer's type of business community. The transaction creating the expense must be expected to occur commonly or frequently in the type of business involved. In order to qualify as a "necessary," the expense must establish that it is appropriate and helpful for the development of the taxpayer's business. Generally, the facts and circumstances of each case determine whether or not an expense is "appropriate and helpful". In addition, expenses must be reasonable in order to qualify as "ordinary and necessary." The facts and circumstances of each case also determine reasonableness.

Employee business expenses may be either reimbursed by the employer or paid by the employee without being reimbursed. If the employer reimburses the expenses, it is critical to identify the type of plan under which such reimbursements are made - accountable or nonaccountable. Expenses reimbursed under an accountable plan are excludable from the employee's wages and exempt from employment taxes. If the expenses are reimbursed under a nonaccountable plan, the employer should include the amount of the reimbursement on the employee's Form W-2, and the employee is responsible for claiming such expenses on his or her tax return as a miscellaneous itemized deduction. Assuming the taxpayer itemizes his or her deductions, miscellaneous deductions are reported on Schedule A of Form 1040 and are deductible only to the extent that such expenses exceed two percent of the taxpayer's adjusted gross income (AGI). (However, see additional limitation on meals and entertainment below).

In order to qualify as an accountable plan, the arrangement must meet the following requirements:

1. The reimbursements, advances, or allowances must be provided for deductible business expenses, which are incurred by the employee in connection with the performance of services as an employee of the employer,

2. The employee must be required to substantiate expenses (discussed below) covered by the arrangement to the person providing the reimbursement, unless the expenses are of a type in which substantiation is not required, and

3. The employee must be required to return any amount in excess of the substantiated expenses.

Whether an arrangement satisfies the above requirements is determined on an employee by employee basis. Therefore, if an employee fails to substantiate expenses under the arrangement, those payments will be treated as an amount received under a nonaccountable plan. However, this will not mean that amounts received by other employees will be treated as amounts received under a nonaccountable plan. Additionally, if a reimbursement arrangement evidences a pattern of abuse of the rules, all payments made under such arrangement will be treated as made under a nonaccountable plan.

A nonaccountable plan is one that does not satisfy one or more of the above requirements. All amounts received under a nonaccountable plan are treated as wages (or other compensation) on the employee's Form W-2, and are subject to withholding and employment taxes. Expenses that qualify as "ordinary and necessary" business expenses may be deducted on the employee's tax return as noted earlier.

Finally, if the employee fails to seek reimbursements for expenses incurred which are reimbursable by the employer, the expenses are not considered to be necessary business expenses and therefore, are not deductible.

Substantiation

Substantiation requirements must be met in order for an employee to be allowed a deduction, or for a reimbursement to be treated as made under an accountable plan. Taxpayers generally must substantiate the amount, time, place, business purpose, and relationship for travel, entertainment and gift expenses. Such expenses must be substantiated by adequate records or by sufficient evidence supporting the taxpayer's statement. An account book, dairy or similar statement, and documentary evidence should be maintained in order to meet the adequate record requirement. However, documentary evidence is required only if the amount of the expense is $75 or more, or the expense relates to lodging while away from home. A written statement of the business purpose is usually required for business expenses, but a taxpayer may be able to establish a business purpose by other evidence if the taxpayer has substantially complied with the adequate records requirement.

Although documentary evidence is not required for expenses that are less than $75, it does not release the taxpayer from establishing each expense. In general, the following four elements must be present in order for a travel, entertainment, or business gift expense to be substantiated:

1. The amount of the expense or item,

2. The time and place of the travel, entertainment, etc. or the date and description of the business gift,

3. The business purpose of the expense or other item, and

4. The business relationship to the taxpayer of the persons entertained or receiving the gift.

In lieu of reimbursing actual expenses, employers may provide employees with per diem allowances. Amounts paid under per diem allowances to employees for lodging, meals, and incidental expenses paid or incurred for business travel while away from home are deemed to be substantiated. The amount of expenses deemed to be substantiated equals the lesser of:

1. The per diem allowance, or

2. The amount computed at the federal per diem rate for the locality of travel for the period that the employee is away from home.

Club Dues

In general, no deduction is allowed for club dues paid or incurred by the taxpayer if the club is organized for business, pleasure, recreation, or other social purpose. The club is considered to be organized for business, pleasure, recreation, or other social purpose if the principle purpose of the club is to provide entertainment activities to its members or their guests. Clubs of this type include, but are not limited to country clubs, golf and athletic clubs, airline clubs, hotel clubs, and business luncheon clubs. The deduction disallowance rules do not apply to the following clubs: business leagues, trade associations, chambers of commerce, professional organizations, and civic or public service organizations. However, the exception is not available if the principle purpose of the club is to conduct entertainment activities for its members or their guests.

If an employer pays an employee's club dues, the amount may be excluded from the employee's income if it qualifies as a working condition fringe benefit. The payment will qualify as a working condition fringe benefit only if the employer does not treat the payment as compensation to the employee, and the amounts paid would otherwise be deductible, except for the provision denying a deduction for club dues. Therefore, if an employee can substantiate 100% business purpose for the club, the payment of club dues may be excluded from the employee's wages. If the employee substantiates less than 100% of a business purpose, the business use portion qualifies as a working condition benefit and excludable from the employee's income while the personal use portion is considered to be compensation and includable in the employee's Form W-2.

Some clubs also require initiation fees to be paid. Initiation fees are distinguishable from annual fees because initiation fees are payable only once and cover the entire period of time that the member belongs to the club or organization, while membership fees (or dues) are recurring

expenses. If an employer pays for an employee's initiation fees, then such payments constitute a taxable fringe benefit which are fully included in the employee's compensation (Form W-2).

Meals and Entertainment

Generally, the deduction for meals and entertainment is limited to 50 percent of such expenses. Expenses related to meals and entertainment, such as taxes, tips, cover charges, rental charges for a room, or parking fees are included in the cost of meals and entertainment and subject to the 50 percent limitation. Employees report the amount of allowable meals and entertainment expenses as a miscellaneous itemized deduction (subject to the 2% of AGI limitation) on Form 2106.

The percentage limitation is generally applied to the person who makes the reimbursement unless the reimbursement is included in the employee's gross income. For example, if a reimbursement is made under an accountable plan, the payment is excluded from the employee's wages, and the employer must apply the limitation in determining the amount of deduction. Likewise, if a reimbursement is made under a nonaccountable plan, the payment is included in the employee's wages and the employee must report the deduction. The employer's deduction for wages is not reduced by the percentage limitation while the employee's deduction for meals and entertainment is reduced to 50 percent of qualifying expenses.

In order for a meals and/or entertainment expense to be deductible, it must meet the following criteria:

1. The expense is directly related to the active conduct of the taxpayer's trade or business,

2. The expense is not lavish or extravagant, and

3. The taxpayer must generally be present at the meal or event.

In addition, business must be discussed before, during or after the meal in order for the expense to be deductible.

There are a few exceptions to the 50% limitation for meals and entertainment expenses. Further information is available upon request.

Travel Expenses and Spousal Expenses

Taxpayers are allowed a deduction for ordinary and necessary travel expenses while away from home in pursuit of trade or business. Travel expenses include travel fares, meals and lodging, and expenses incident to travel such as expenses for sample rooms, telephones, hotel rooms, etc. A traveler is away from home if the traveler cannot reasonably be expected to complete the round trip without obtaining sleep or rest, and the travel is away from the general area of the

traveler's tax home. Travel expenses may not be lavish or extravagant, and may not relate to the taxpayer's own personal expenses.

It is common for spouses to accompany an employee on a business trip. In order for the travel expenses of the spouse to be deductible, the following conditions must be met:

1. The spouse is an employee of the taxpayer,

2. The travel of the spouse is for a bona fide business purpose, and

3. The expenses are otherwise deductible by the spouse.

If the spouse does not meet these requirements, any reimbursements for such amounts must be included in the compensation of the employee unless the payment qualifies as an excludable "working condition" fringe benefit. Payments for spousal travel will be excluded from the employee's gross income as a "working condition" fringe benefit if the employer has not treated the payment as compensation, the spouse's presence on the trip has a bona fide business purpose, and the substantiation requirements are met. **Please note, however, that the Internal Revenue Service closely scrutinizes spousal travel and employees should carefully document valid business reasons for spouses accompanying them on business trips in order to qualify for the exclusion from taxable income.**

If an employee is reimbursed for travel expenses, the tax treatment of such expenses depends on whether the reimbursement (or allowance) was made through an accountable or nonaccountable plan (as discussed earlier). Reimbursements under an accountable plan are excluded from the employee's wages and exempt from employment taxes. Reimbursements under a nonaccountable plan are included in the employee's wages and the employee is responsible for claiming the expenses as a miscellaneous itemized deduction (subject to the 2 percent of AGI limitation) on Form 2106. If a taxpayer receives payments for spousal travel that are not excludable as a working condition fringe, the payments are likewise included in the employee's wages.

Fringe Benefits

Employers often provide certain fringe benefits to employees, which are taxable as compensation to the employee unless they are specifically excluded under the IRC. Two examples of excludable fringe benefits, similar to the working condition fringe benefit described above, are *de minimis* fringes and no-additional-cost services.

De Minimis Fringe Benefits

Certain benefits have a value that is so small that accounting for them is unreasonable or impractical. Such benefits are called *de minimis* fringe benefits. In determining whether a

benefit qualifies under this exclusion, the frequency with which similar fringes are provided to employees must be considered. Examples of *de minimis* fringe benefits include occasional typing of personal letters by a university secretary, coffee, soft drinks, local telephone calls, and occasional cocktail parties, group meals or picnics for employees and their guests.

No-Additional-Cost Services

No-additional cost services result from excess capacity because an employer has incurred fixed cost to provide a specific level of capacity, and such capacity is not always used. Therefore, an employer may provide services to an employee for their personal use that is also offered by the employer for sale in the ordinary course of business. If the employer incurs no substantial costs in providing the services to the employee, the services are no-additional cost services and may be excluded from the employee's gross income. No-additional cost services may be excluded from a highly compensated employee if the services are provided on substantially the same terms to all employees in a way that such benefits do not discriminate in favor of highly compensated employees.

Example - Tickets to Athletic and Other Community Events

It is common practice for the UAB Educational Foundation to give tickets to various athletic and community events to employees and business contacts. If such tickets are **occasionally** provided to the employees or business contacts, the value of the ticket may be excluded from the recipient's gross income as a *de minimis* fringe benefit. **However, season tickets to athletic or theatrical events are two examples that do not qualify as *de minimis* fringe benefits, and are included in the recipient's gross income.** In addition, the frequency with which the employer provides the tickets must be considered in determining whether or not the tickets can be classified as a *de minimis* fringe benefit. For example, **tickets that are frequently provided to one individual employee but not all employees are not *de minimis* fringe benefits, and therefore, are taxable to that employee. Likewise, tickets provided to certain groups of employees (such as highly compensated employees) but not other groups, would not be considered excludable *de mimimis* fringe benefits and should be reported as taxable compensation on Form W-2 subject to withholding.**

Employee Gifts and Employee Achievement Awards

Subject to a few exceptions, amounts transferred by an employer to an employee are compensatory in nature and may not be excluded from income as gifts. For example, the value of turkeys, hams or other items of nominal value distributed to employees at Christmas or other holidays are excluded from the employees' income. However, if the employer distributes cash, gift certificates, or similar items that are easily exchangeable into cash, the value of the gift is income to the employees.

Another exception is an employee achievement award. Employee achievement awards may generally be excluded from the employee's gross income to the extent that the aggregate cost of all such awards does not exceed $400 for the same employee and such amount is not made under a qualified plan. If an award is made under a qualified plan, the aggregate cost of all such awards increases to $1,600. A qualified plan is a written plan that does not discriminate in favor of highly compensated employees. Employee achievement awards are items of tangible personal property that are:

1. Transferred by the employer to the employee for length of service or a safety achievement,

2. Given as part of a meaningful presentation, and

3. The award does not create a significant likelihood of being regarded as disguised compensation.

Please note that these rules do not necessarily consider an individual's position with an organization, other than by length of service.

Certain retirement gifts may qualify as either employee achievement awards *or de minimis* fringe benefits, depending on the facts and circumstances surrounding the gift. The regulations provide that under appropriate circumstances, a traditional retirement award will be treated as a *de minimis* fringe. Although "traditional" is not clearly defined, it may be possible to classify certain length of service (retirement) gifts as *de minimis* fringe benefits excludable from income, despite the $400 limitation. **As a general rule, the $400 limitation should be enforced to avoid IRS scrutiny, unless an employee's length of service justifies a gift valued over $400 and the basis for such gift is appropriately documented.**

Business Gifts

On many occasions, a taxpayer may provide gifts to clients, customers, and business contacts. Business gifts to nonemployees are excluded from the recipient's gross income unless such gifts are deemed "in lieu of compensation." If a gift is considered to be compensation, such amount should be reported to the recipient on a Form 1099. The deduction for business gifts is generally subject to a $25 limitation per individual.

Memorial Contributions

On occasion, a taxpayer may provide memorial contributions to churches or other charitable organizations on behalf of a deceased employee. The contributions are generally less that $100, and, in total, they are an insignificant expenditure of the foundation. After a review of the tax law governing Section 501(c)(3) organizations that support publicly-supported organizations, we found nothing that precludes these memorial contributions.

Political and Lobbying Expenditures

Because the UAB Educational Foundation is a charitable organization, it is limited on the amount of political activities that it may engage in. In general, no substantial part of the charitable organization's activities may consist of lobbying activities. Lobbying activities may consist of carrying on propaganda, or attempting to influence legislation. If a charitable organization engages in a substantial amount of lobbying activities, the organization may lose its tax-exempt status and will be subject to an excise tax on the lobbying expenditures.

There is no direct guidance on the definition of "lobbying activities." However, lobbying activities could include contacting or urging the public to contact members of a legislative body for the purpose of proposing, supporting, or opposing legislation, and advocating the adoption or rejection of legislation.

Exempt charitable organizations are strictly prohibited from engaging in campaigning activities. Participating, either directly or indirectly, in any political campaign on behalf or in opposition to any candidate for political office is prohibited and will result in a loss of the organization's tax-exempt status. This includes candidates running for national, state, or local office. Prohibited activities also include publishing or distributing written or printed statements or making oral statements on behalf of or in opposition to a candidate.

It is extremely important that exempt organizations such as the UAB Educational Foundation monitor certain political expenditures to ensure that they would not be considered political campaign activities and that any lobbying expenditures do not become substantial because the organization's exempt status could be jeopardized by such activities.

Please note that the above outline is a general discussion of the various rules described and should not be used as a sole resource in examining tax issues. Each situation or transaction should be examined based on its own merits.

If you have any questions or would like to discuss any of the above issues, please call Thomas Lee at 250-8529 or Scott Browning at 250-8544.

Very truly yours,

PricewaterhouseCoopers LLP

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