

**PROPOSED REGULATIONS FOR  
INTERMEDIATE SANCTIONS RULES**

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On July 30, 1998, some two years after the enactment of Section 4958, the Internal Revenue Service issued proposed regulations under the “intermediate sanctions” rules that govern transactions between Section 501(c)(3) and (4) organizations and persons “in a position to exercise substantial influence” over the affairs of such organizations. The proposed regulations were nearly as long in the making as the statute itself, and they reflect a significant effort on the part of the IRS to provide more detailed guidance about the application of a statute that is hardly a model of clarity. Writing these proposed regulations was daunting, however. Many questions remain, and the IRS has identified and invited comments about some of these open issues.

Comments on the proposed regulations are due on November 2, 1998. We expect that the IRS will hold a public hearing to receive testimony on the proposed regulations, and — depending on the nature and volume of comments — might finalize them sometime next year. This paper provides a brief overview of Section 4958, describes the principal provisions of the proposed regulations and highlights certain areas that need clarification.

## **I. Overview of Section 4958**

Section 4958 imposes an excise tax on a “disqualified person” who engages in an “excess benefit transaction” with a Section 501(c)(3) or 501(c)(4) organization (other than a private foundation). It also imposes a penalty on an organization manager who knowingly approves such a transaction. These penalties are called “intermediate sanctions” because they may be imposed by the IRS in lieu of (or in addition to) revocation of exemption.

### **A. Definition of “Disqualified Person”**

Section 4958 defines a “disqualified person” as anyone who, during the five-year period ending on the date of the transaction in question, was “in a position to exercise substantial influence over the affairs of the organization,” as well as certain family members and entities in which the disqualified person has a 35 percent ownership interest. This standard has been criticized as ambiguous, and although the proposed regulations provide some guidance on this issue, many questions remain.

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## **B. Definition of Excess Benefit Transaction**

Section 4958 defines an excess benefit transaction as (1) a transaction in which the economic benefit provided directly or indirectly to a disqualified person exceeds the value received by the organization (including performance of services); and (2) *to the extent provided by IRS regulations*, any transaction in which a disqualified person receives an economic benefit that is determined in whole or in part by the revenues of the organization, but only if such transaction results in inurement as defined under current law. The first part of the definition of “excess benefit transaction” is fairly straightforward and includes the payment of excessive compensation or an unreasonable business transaction. The second provision is more complex, and is intended to include compensation payments that, even though reasonable in amount, are paid pursuant to a methodology that puts the disqualified person’s interests in conflict with the interests of the organization. The second provision is addressed in the proposed regulations but will not become effective until the IRS issues final regulations.

## **C. Presumption of Reasonableness**

The legislative history of Section 4958 provides that existing law determines the reasonableness of compensation and fair market value, and makes it clear that boards of directors and compensation committees are the appropriate parties to ensure that exempt organizations are in compliance with the new rules. To encourage proper scrutiny by such parties, the legislative history indicates that there is to be a rebuttable “presumption of reasonableness” for a transaction approved by a board or committee that

- (1) is composed of individuals unrelated to and not subject to the control of the disqualified person;
- (2) obtains and relies upon appropriate data on comparability or value; and
- (3) adequately documents the basis for its determination.

The proposed regulations describe in greater detail the procedures that must be followed to obtain the benefits of this “presumption of reasonableness.”

## **D. Imposition of Excise Taxes**

The excise taxes imposed under Section 4958 can be substantial. Disqualified persons are subject to a first-tier tax of 25 percent of the amount of the excess benefit, as well as a second-tier tax of 200 percent unless the transaction is “corrected” by repaying the amount of the excess benefit to the exempt organization. Organization managers who knowingly approve an excess benefit transaction are also subject to a penalty tax of 10 percent of the excess benefit (up to a maximum of \$10,000). Section 4958 does not impose an excise tax on the organization.

## **II. The Proposed Regulations**

The proposed regulations contain more detailed definitions of the key statutory terms, including the definitions of disqualified person and excess benefit transaction. They create several safe-harbors that are not in the statute itself, and use numerous examples to illustrate the application of the principles outlined in the proposed regulations. Taken together, these provide some helpful guidance for exempt organizations, although the examples tend to involve situations that are “clearly good” or “clearly bad,” and — as practitioners and exempt organizations are sure to observe in their comments to the IRS — generally do not grapple with the difficult issues in the middle.

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The proposed regulations also contain a preamble which solicits comments about several issues that are not addressed in the proposed regulations. These issues include the use of options as compensation (a new compensation technique being explored by some exempt organizations); the rules governing whether an economic benefit will be treated as compensation even if the organization did not manifest an intention to do so; and ways to apply the statute to minimize burdens on affected organizations.

#### **A. Definition of a Disqualified Person**

The starting point in applying Section 4958 is to determine who is a disqualified person. Since Section 501(c)(3) and (4) organizations typically have no intention of entering into excess benefit transactions, this determination is relevant mainly so that they can identify the persons for whom they need to approve and document transactions (including the payment of compensation) in accordance with the requirements to qualify for the presumption of reasonableness. The proposed regulations grapple with the difficult and ambiguous statutory definition of a “disqualified person” by establishing some bright-line rules, as well as some “facts and circumstances” determinations.

##### **1. Disqualified Person by Reason of Position**

The proposed regulations provide that certain categories of individuals are considered by reason of their relationship to the organization to exert substantial influence over its affairs and therefore to be disqualified persons. These include:

- voting members of the organization’s governing board
- presidents, chief executive officers or chief operating officers and others who, regardless of title, have or share ultimate responsibility for the decisions of the governing body or supervise the management, administration or operation of the organization
- treasurers, chief financial officers and others who, regardless of title, have or share responsibility for managing the organization’s financial assets and who can authorize the use of the organization’s funds
- persons with a material financial interest in a provider-sponsored organization.

**Observation:** In general, the characterization of persons holding these positions as automatically disqualified seems logical and appropriate. The difficulty is how to determine which persons — other than those named by position — meet the “have or share responsibility” standard. The proposed regulations do not provide any examples of how that standard is met, leaving exempt organizations in a quandary on this fundamental issue.

##### **2. Disqualified Person by Reason of Facts and Circumstances**

In addition to the automatic classification of certain persons as disqualified persons, the proposed regulations provide that others may be considered to have substantial influence over the affairs of

the organization and therefore are disqualified persons based on an examination of all the facts and circumstances. The proposed regulations cite the following factors as “tending to show” the existence of such substantial influence:

- the person founded the organization
- the person is a substantial contributor (i.e., has given more than 2 percent of the total contributions received by the organization)
- the person’s compensation is based on revenues from activities of the organization under his or her control
- the person has authority to control a significant portion of the organization’s capital expenditures, operating budget or compensation for employees
- the person has managerial authority or serves as a key adviser to a person with managerial authority
- the person has a controlling interest in a corporation, partnership or trust that is a disqualified person.

**Observations:** While these facts and circumstances provide some guidance, they are very broadly inclusive — perhaps overly so. For example, in large organizations many persons either “have managerial authority” or are “key advisers” to persons with such authority, at least in the common-sense usage of these terms. These persons may, however, be several management layers below the persons who report directly to the chief executive, operating and/or financial officers. Under the proposed regulations, it remains unclear how many layers deep into the organizational chart the disqualified person status reaches. The IRS is likely to receive many comments requesting that these standards be clarified.

In addition, many exempt organizations have persons below the management level who receive compensation based on revenues from activities over which they have some degree of control. The most common example is organizations that compensate persons who sell advertising in their periodicals on a commission basis. This is a customary arrangement, yet advertising salespeople typically do not have substantial influence over the affairs of the organization and — but for this “fact and circumstance” — would not appear to be disqualified persons. Similarly, some institutions have royalty-sharing arrangements with inventors; typically these individuals do not have the requisite substantial influence over the organization to be a disqualified person, but the proposed regulations nevertheless suggest that they may because of their compensation arrangement.

### 3. Other Categories of Disqualified Persons

The proposed regulations also provide that persons with certain statutorily-defined relationships with disqualified persons are themselves disqualified persons. This includes those with a family relationship with a disqualified person, such as a spouse, siblings and their spouses, ancestors,

children, grandchildren, great-grandchildren and their spouses. It also includes entities in which a disqualified person controls more than 35 percent of the combined voting power, represented by ownership of stock in the case of a corporation, 35 percent of the profits interest in the case of a partnership, and 35 percent of the beneficial interest in the case of a trust or estate. The constructive ownership rules of Section 267(c), which deem the interests in an entity of certain types of related persons to be owned by each other, determine whether these control tests are met.

## **B. Persons Who Are Not Disqualified Persons**

The proposed regulations contain a much shorter list of those who are not considered disqualified persons, based on their positions with the organization or on certain facts and circumstances that do not tend to show the existence of substantial influence over the affairs of the organization.

### **1. No Disqualified Person Status by Reason of Position**

The list of persons who are not disqualified persons by reason of position includes only other Section 501(c)(3) organizations and employees whose compensation is less than the amount defined for a “highly compensated employee” under Section 414(q)(1)(B)(i) — currently \$80,000 — provided that such employees are not in one of the other categories described in paragraph A1 above and are not substantial contributors to the organization. For example, if the chief financial officer receives compensation of \$75,000, he or she will still be considered a disqualified person because persons holding that position are automatically considered disqualified persons.

### **2. No Disqualified Person Status by Reason of Facts and Circumstances**

The proposed regulations also list some facts and circumstances tending to show that a person does not have substantial influence, including the following:

- the person has taken a bona fide vow of poverty as an employee or agent or on behalf of a religious organization
- the person is an independent contractor, such as an attorney, accountant, investment manager or adviser acting in that capacity
- the person receives no preferential treatment as a result of the size of his or her donation that is not offered to others making a comparable donation.

**Observation:** Although the proposed regulations carve out “independent contractors” as not likely to be disqualified persons, the examples make it clear that this exception should be construed narrowly to cover professionals such as lawyers, accountants and investment advisers, and not independent contractors whose arrangements with the organization involve one or more of the factors listed in paragraph A2 above. In fact, the examples illustrating these definitions make it clear that — in the IRS’ view — an independent contractor may become a disqualified person by virtue of a contract that gives it managerial authority or control over an organization’s principal source of income, even if the organization had no prior relationship with the contracting party. This position appears to be based on the decision in the *United Cancer Council* case, in which the Tax Court held that a fundraiser became an “insider” for inurement purposes on the date that it entered into a contract with the Section 501(c)(3) organization. That case is currently on appeal. Pending final resolution of this issue, however, organizations should consider taking

steps to approve and document major contracts and joint ventures in accordance with the requirements for obtaining the “presumption of reasonableness.”

In addition, the statement in the proposed regulations regarding the treatment of donors might be read to suggest — at least to an IRS revenue agent — that if a major donor does receive preferential treatment, he or she is more likely to be a disqualified person. Such an interpretation could limit the flexibility of development offices in making special arrangements with individual major donors. In many cases, whatever benefits go back to the donor as a *quid pro quo* should simply reduce the amount of his or her charitable contribution deduction, and should not be considered “excess benefits” under Section 4958. Further guidance may be needed on this issue.

### **C. Excess Benefit Transactions**

The proposed regulations expand on the issue of what constitutes an excess benefit transaction, including excessive compensation and certain types of revenue-sharing arrangements.

#### **1. Reasonableness Standard**

In general, the proposed regulations use a standard of reasonableness to determine whether the payment of compensation results in an excess benefit transaction. Compensation for the performance of services is considered reasonable if it is an amount that would ordinarily be paid by similarly situated organizations under like circumstances. This determination is generally based on the facts that existed at the time of execution of the contract. The proposed regulations make it clear that circumstances existing on the date the contract is questioned cannot be taken into account in determining the reasonableness of the compensation paid thereunder — in other words, neither the IRS nor the taxpayer is entitled to use hindsight to attack or justify an arrangement under challenge.

**Observation:** The proposed regulations treat a contract that is terminable or subject to cancellation by the organization without the disqualified person’s consent as a new contract as of the date that any such termination or cancellation, if made, would be effective. Similarly, any material modification to a contract, including the extension of the contract’s term or an increase in the compensation paid to the disqualified person, will be treated as a new contract as of the date of modification. This provision will cause many “evergreen” employment agreements to be treated as new contracts upon the expiration of the period for giving notice of nonrenewal.

#### **2. Sources of Compensation**

In making a determination of reasonableness, the proposed regulations provide that all sources of compensation paid by the organization to the disqualified person will be considered, including:

- all cash and noncash compensation
- all deferred compensation that is earned and vested
- the amount of insurance premiums as well as reimbursements for charges not covered by insurance
- all other benefits provided by the organization, both taxable and nontaxable, and expense

allowances or foregone interest on loans that the disqualified person must report as income

- any economic benefit provided by the organization, whether provided directly or indirectly through an affiliated or controlled taxable or tax-exempt entity.

In order to claim that an economic benefit provided to a disqualified person is compensation, the proposed regulations require the organization to provide clear and convincing evidence of this intent. Such evidence includes an applicable federal tax information return, such as a W-2 or 1099 or Form 990, which lists the item as compensation and which was filed prior to the commencement of an IRS audit. There is a reasonable cause exception for mitigating factors or events beyond the organization's control, such as computer error or malfunction.

**Observations:** Many exempt organizations focus primarily on cash compensation. The proposed regulations make it clear that all sources of compensation must be examined, not just the cash components. This applies in establishing the reasonableness of compensation and in documenting that fact for the presumption of reasonableness.

It is also critical for exempt organizations to document their intent to treat amounts as compensation because, under the proposed regulations, the failure to do so may preclude the organization from arguing that such amounts are reasonable and therefore not an excess benefit transaction. Exempt organizations in particular need to review their reporting of benefits, nonqualified deferred compensation and other elements of compensation that are not shown on the W-2 in order to ensure that such amounts are properly reported on the Form 990.

### 3. Revenue-Sharing Transactions

Pursuant to authority granted under Section 4958, the proposed regulations define an excess benefit transaction to include certain types of revenue-sharing arrangements. In general, the inquiry is whether the arrangement permits a disqualified person to receive additional compensation without providing proportional benefits that contribute to the organization's accomplishment of its exempt purposes, and not whether the arrangement provides reasonable compensation for services rendered. Under the proposed regulations, intermediate sanctions may be triggered by a compensation arrangement that results in reasonable compensation if the methodology otherwise fails the proportional benefit test. The proposed regulations provide that relevant facts and circumstances include the relationship between the size of the benefit provided and the quality and quantity of the services provided, as well as the ability of the party receiving the benefit to control the activities generating the revenues on which the compensation is based. Examples of acceptable revenue-sharing arrangements involve a university's sharing of royalties with an inventor and a charity's compensation of an investment portfolio manager based on the annual increase in value of the portfolio.

**Observations:** The revenue-sharing provisions will affect many exempt organizations that have incentive compensation arrangements which include some measure based on the revenues of the organization. It is important to review such arrangements to make sure that they are designed and documented to reflect the benefits that will be produced for the exempt organization, and to ensure that the behavior being encouraged is consistent with the organization's exempt purposes.

The rules with respect to revenue-sharing transactions are prospective, and will be effective when final regulations are issued. Until then, a revenue-sharing arrangement will be considered an excess benefit only if the amount paid exceeds the fair market value of the services provided.

### 4. Transfer of Property

In determining whether the transfer of property constitutes an excess benefit transaction, the proposed regulations take a straightforward approach and look to whether the consideration paid exceeds the fair market value of the property transferred. For these purposes, “fair market value” is defined as the price at which property or the right to use property would change hands between a willing buyer and willing seller, without compulsion and with each having reasonable knowledge of the relevant facts.

## 5. Other Potential Excess Benefit Transactions

The proposed regulations clarify that certain economic benefits provided by an organization are disregarded for purposes of Section 4958. These include economic benefits received by disqualified persons in their capacity as members of an organization, if such benefits are provided to members of the public in exchange for a membership fee of \$75 or less per year. In addition, the payment of insurance premiums for an insurance policy providing liability insurance for Section 4958 excise taxes or an indemnification for such taxes will not be considered an excess benefit if such premium is treated as compensation when paid and the person’s total compensation is reasonable. The proposed regulations also provide that the payment of reasonable expenses of members of the governing body to attend meetings may be disregarded for purposes of Section 4958; for these purposes, however, reasonable expenses do not include “luxury” travel — which is not defined — or spousal travel.

Finally, the proposed regulations note that an excess benefit may be provided directly or indirectly through the use of entities controlled by or affiliated with the exempt organization. For example, an excess benefit transaction is deemed to occur if an exempt organization causes its taxable subsidiary to pay excessive compensation or engage in a transaction at other than fair market value with a disqualified person of the parent organization.

**Observations:** In the absence of a definition of “luxury travel,” organizations must exercise caution in holding board meetings at luxury resorts where the schedule permits considerable recreational time. In addition, the payment of spousal travel expenses typically constitutes taxable income to directors and/or officers who bring their spouses to board meetings, and it is important that such expenses be included on W-2 or 1099 forms.

The potential treatment of payments made by taxable subsidiaries to disqualified persons as excess benefit transactions may cause some concerns, primarily because exempt organizations are — for other tax law purposes — encouraged to stay out of such day-to-day management decisions. Presumably this provision is intended to reach only situations where an organization is attempting to evade the application of Section 4958 by using a taxable subsidiary to make payments that it could not make directly, but this is an issue that should be clarified in final regulations. Pending such clarification, organizations should attempt to monitor any payments by taxable subsidiaries to disqualified persons, to ensure that such payments are made and documented in accordance with the standards for the presumption of reasonableness described below.

### D. Definition of Organization Manager

Under Section 4958, “organization managers” may be subject to excise tax liability if they participate knowingly in an excess benefit transaction. The proposed regulations define an organization manager as any officer, director or trustee, or any individual with similar responsibilities. The term “officer” is used broadly to include any individual who is so designated under the governing documents of the organization, or who regularly exercises general authority to make administrative or policy decisions on behalf of the organization. The latter category does not include independent contractors, such as attorneys, accountants and investment managers and advisors acting in their capacity as such. Nor does it include individuals who have the

authority to simply recommend action, but who do not have the authority to implement such recommendations without the approval of a superior.

### **1. Definition of Participation**

An organization manager's participation in an excess benefit transaction includes silence or inaction when the organization manager is under a duty to speak or act, as well as any affirmative action taken by such individual. In the event an organization manager opposes the transaction in a manner consistent with his or her obligations to the organization, such individual will not be considered to have participated in the transaction.

**Observation:** Organization managers who wish to record their opposition to a proposed transaction should not merely abstain from voting, but should vote against the transaction and request that the minutes of the meeting document such action.

### **2. Definition of Knowing**

An organization manager will only be considered a knowing participant in an excess benefit transaction if he or she (1) has actual knowledge of sufficient facts, so that based solely on such facts, such transaction would be an excess benefit transaction, (2) is aware that such act may violate the prohibition against excess benefit transactions and (3) negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction, or the person is aware that it is such a transaction. The proposed regulations provide that having reason to know is insufficient to establish knowledge, although it might be a relevant fact in making such determination.

### **3. Reasonable Cause and Advice of Counsel**

If an organization manager exercises his or her responsibility on behalf of the organization with ordinary business care and prudence, such individual will be deemed to have acted with reasonable cause and will not be subject to excise tax under Section 4958. In addition, if an organization manager acts in reliance upon a reasoned legal opinion of counsel (including in-house counsel) that a transaction is not an excess benefit transaction, such individual will be considered to have acted with reasonable cause. The legal opinion relied upon by the organization manager must address itself to the facts of the transaction and the applicable law. It may not simply recite the facts and express a conclusion. The proposed regulations also provide that the absence of a legal opinion will not give rise to the inference that the organization manager acted knowingly or without reasonable cause.

**Observation:** Many organizations regularly seek opinions of counsel on whether their executive compensation arrangements are in compliance with the requirements of Section 4958. This is particularly important for organizations that offer incentive compensation arrangements. Although the proposed regulations provide that an opinion from in-house counsel generally is sufficient to establish reasonable cause, that may not follow if such counsel is a disqualified person who is involved in the arrangement for which the opinion is being sought. In addition, the advice of counsel exception, as currently written, does not extend to advice provided by other tax professionals, such as accounting firms.

## **E. Rebuttable Presumption**

The proposed regulations create a rebuttable presumption that compensation paid to a disqualified person is reasonable and that a transfer of property is at fair market value if the following conditions are satisfied: (1) the compensation arrangement or transaction is approved by the organization's governing body or a committee composed of members who do not have a conflict of interest; (2) such approval was made in reliance upon appropriate data as to comparability; and (3) the basis for the determination was adequately and concurrently documented. To be documented concurrently, records must be prepared by the next meeting of the body approving the transaction. Under the proposed regulations, so long as the above three requirements are met and local law permits, the governing body of an organization may authorize other parties to act on its behalf in approving such transactions and still avail itself of the presumption of reasonableness. For organizations incorporated in states which permit the delegation of board functions to nonboard committees, this will allow the directors to delegate determinations about their own compensation to an outside committee and thereby qualify for the presumption of reasonableness.

If the governing body of an organization relies on a committee with respect to the approval of a specific transaction, the members of such committee will be considered organization managers for purposes of the excise tax on organization managers, regardless of their relationship to the organization. The proposed regulations make it clear, however, that a person who (1) meets with other members of the governing body or the committee considering a specific transaction only to answer questions, (2) otherwise recuses himself or herself from the meeting and (3) is not present during debate and voting on the transaction or compensation arrangement, will not be considered a member of such governing body or committee.

Under the proposed regulations a member of the governing body or committee does not have a conflict of interest with the approval of a transaction or a compensation arrangement with a disqualified person if he or she: (1) is not a disqualified person and is not related to the disqualified person; (2) is not in an employment relationship subject to the direct control of the disqualified person; (3) is not receiving compensation or other payments subject to the approval of the disqualified person; (4) has no material financial interest affected by the transaction or arrangement; and (5) does not approve a transaction providing economic benefits to the disqualified person, who in turn has approved or will approve a transaction providing economic benefits to the member.

The proposed regulations provide that comparability data must be sufficient, given the knowledge and expertise of the members, for them to determine that the compensation was reasonable or that the transaction was at fair market value. Such data may include information regarding the 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 organization; independent compensation surveys compiled by independent firms; written offers from similar organizations competing for the services of a particular individual; and independent appraisals of property.

If an organization has gross receipts of less than \$1 million, it may rely on data of compensation paid by five comparable organizations in the same or similar communities for similar services. An organization may look at the rolling average based on the three prior taxable years to calculate its gross receipts for these purposes. In addition, the annual gross receipts of all related organizations must be aggregated when making this calculation.

The proposed regulations also set out the requirements for adequate documentation. In this regard, the record must include (1) the terms of the transaction and the date approved, (2) the members who were present during consideration of the transaction or arrangement and those who voted on it, (3) the comparability data relied on and the manner in which it was obtained, and (4) the actions taken by those members of the approving body who had a conflict with respect to the transaction, i.e., whether they recused themselves or left the room during the debate and vote. In addition, if the governing body or committee determines that reasonable compensation

or fair market value is higher or lower than the range specified in the comparability data, it must record the basis for this decision.

**Observation:** Many exempt organizations have tried to keep the minutes documenting approval of compensation arrangements “short and sweet” because they consider the compensation decision-making process highly sensitive and confidential. However, the proposed regulations make it clear that more documentation is better than less, and exempt organizations need to ensure that the executive compensation decisions made by the board or compensation committee provide an adequate record of the deliberations leading to the compensation decisions.

#### **F. Applicable Tax-Exempt Organization**

The excise taxes contained in Section 4958 and the proposed regulations are imposed on a disqualified person who engages in an excess benefit transaction with an “applicable tax-exempt organization.” This is defined as any organization that “would be described” in Section 501(c)(3) or 501(c)(4) and exempt from tax under Section 501(a). The proposed regulations provide that an organization “would be described” in Section 501(c)(3) if it is subject to Section 508 (which requires Section 501(c)(3) organizations to apply for tax exemption). The proposed regulations also make it clear that foreign organizations that receive substantially all of their support from sources outside the United States are not subject to the reach of Section 4958, even if such organizations have been determined to be foreign equivalents of U.S. public charities.

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