

IRS Issues Report on Not-for-Profit Executive Compensation

The methodology utilized for setting compensation paid to executives at not-for-profit (tax exempt) hospital enterprises has recently come under heightened scrutiny with the release of the widely-anticipated Internal Revenue Service (IRS) report on not-for-profit executive compensation practices. Results from the February 2009 IRS' *Exempt Organizations (TE/GE) Hospital Compliance Project Final Report* ("2009 IRS Final Report")¹ indicate that while executive compensation is high, most hospitals followed the "rebuttable presumption" process for determining compensation levels, thereby resulting in a defensible executive compensation pay-setting policy under the Internal Revenue Code.¹

The "rebuttable presumption," provisions of the Internal Revenue Code states that compensation paid to a *disqualified person*, or one who is *in a position* to exert substantial influence over that organization during the time the compensation was being decided will be presumed to be at Fair Market Value (FMV) if three conditions are met: (1) the compensation is approved by an authorized body whose members have no conflicts of interest; 2) compensation has been set based on a reliance of comparable data; and, 3) the authorizing body adequately, and concurrently, documented the basis for its determination; the compensation it pays to a disqualified person is presumed to be at fair market value.¹ While the IRS does not *require* tax-exempt organizations to meet all three prongs of the rebuttable presumption test when setting executive compensation,¹ failure to meet any one of the three prongs of the test suggests an excess benefit transaction and places the tax exempt organization at risk for immediate intermediate sanctions as well as the potential to lose its tax-exempt status.¹ Additionally, although the rebuttable presumption provides a helpful, three-step process for ensuring that compensation is set at FMV, the presumption has come under recent scrutiny, e.g., the IRS's 2007 *Report on Exempt Organizations Executive Compensation Compliance Project* (an interim report issued prior to the 2009 IRS Final Report) regarding how hospitals pay their executives, suggested that, while most hospitals rely on the rebuttable presumption process, there were significant variations in how tax exempt hospitals accounted for, and reported, bad debt, community benefit, and uncompensated care. These

variations, together with the major finding of the 2009 IRS Final Report that executive pay rates remained high despite substantial industry compliance with the rebuttable presumption test, has prompted questions about the validity of the comparables utilized, and left doubt as to whether the rebuttable presumption test really sets compensation at FMV.¹ While the high executive pay rates may be defensible under the rebuttable presumption process, the use of comparability data may be rebutted if the IRS develops sufficient contrary evidence to refute the probative value of the comparability data relied on by the authorized body.¹

Representatives and attorneys at tax-exempt organizations have stated that comparables used to set executive compensation in tax-exempt hospital enterprises have mostly included other tax-exempt organizations in the healthcare community. Doug Mancino, Esq., a partner at McDermott, Will & Emery, stated in a recent *BNA's Health Law Reporter* news release that tax-exempt organizations do not "cherry pick for-profit data to increase the amount they are paying executives." The above mentioned 2007 IRS Interim Report on executive compensation appears to support his claim. Results from the IRS survey, while not statistically valid or generalizable to other organizations, indicated that, of 782 tax-exempt organizations contacted by the IRS, 54% of the organizations used comparability studies in setting compensation, 97% of which used comparables from similarly sized and typed organizations.¹ Additionally, results from the 2009 IRS Final Report on exempt organizations found that, of the 478 respondents from tax-exempt hospitals, 100% used comparability data from other tax-exempt hospitals and set their compensation within the comparability range. Eighty-seven percent of tax-exempt hospitals also used published surveys as a factor in setting executive compensation.¹

The 2009 IRS Final Report also indicated that the use and compliance with the rebuttable presumption is widespread, with 85% of examined hospitals meeting all the rebuttable presumption requirements.¹ Additionally, the 2009 IRS Final Report indicated that approximately 98% of tax-exempt hospitals had executive compensation levels approved in advance by someone without a conflict of interest in the organization.

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However, while compliance with the rebuttable presumption process appears high, only 73% of respondents reported having a formal, written compensation policy.¹¹

Despite the final report's widespread anticipation, Senator Charles Grassley (R-Iowa), a ranking Republican on the Senate Finance Committee and long-standing critic of the finances of tax-exempt organizations was critical of the 2009 IRS Final Report indicating that he was disappointed it didn't also include a study of for-profit executive compensation in order to further differentiate the non-profit compensation rates studied.¹² Additionally, although the average total compensation paid to not-for-profit hospitals top executives was \$490,431, a selection of 20 large tax exempt hospitals indicated executive compensation levels to be over \$1.4 million, thereby suggesting a wide discrepancy between executive compensation at different sized hospitals.¹³

It should be noted that the 2009 IRS Final Report did not make any policy change recommendations. However, there has been some concern raised by the not-for-profit hospital community that the results of the 2009 IRS Final Report will be used to champion executive pay caps similar to the ones recently created for the financial sector.¹⁴

Additionally, while no changes were made to the rebuttable presumption test, the IRS has indicated that they will provide future guidance on the use of the "initial contract exception," which exempts certain fixed payments detailed in the terms of the executive's initial contract. To qualify for the initial contract exception, the following criteria must be met: (1) the executive must not have been a disqualified person immediately prior to entering into the contract; (2) the amount must be specified or determined by a fixed formula as provided for in the contract; and, (3) any payments must be for specified property or services, such as future events or contingencies (e.g., performance benchmarks). Once the compensation formula is included within the executive's contract provisions, there is no discretion when calculating the amount to be paid to the executive.¹⁵ Several conditions can disqualify these contracts from the exception, including an organization's ability to unilaterally terminate the contract without

significant penalties, as well as subsequent material changes in the contract language related to extending or renewing the contract term, as well as materials changes in the amount payable to the executive. These disqualifications result in the compensation to be paid to the executive undergo a FMV analysis under the rebuttable presumption criteria discussed above.¹⁶

While the debate continues over both the appropriateness of the use of comparables and the rebuttable presumption test as indicators of FMV, these issues only highlight problems with current executive pay-setting policies in the not-for-profit arena, as well as the IRS' increased presence in the healthcare sector. At the Annual Western Conference on Tax Exempt Organizations on November 20, 2008, Steven Miller, Commissioner of the IRS' Tax Exempt and Government Entities Division, stated that the IRS will remain "exceptionally active" in the review of and push for greater transparency of tax-exempt organizations.¹⁷ Organizations that wish to avoid scrutiny will need to provide documented evidence of their attempt to set executive pay at FMV as well as their attempt to serve the community in exchange for their tax-exempt status.

¹ "Exempt Organizations Hospital Compliance Project Final Report," Internal Revenue Service, February 13, 2009, www.irs.gov

² "Exempt Organizations Hospital Compliance Project Final Report," Internal Revenue Service, February 13, 2009, www.irs.gov

³ "An Introduction to I.R.C. 4958 (Intermedia Sanctions)," By Lawrence M. Brauer, Toussaint T. Tyson, Leonard J. Henzke, and Debra J. Kaweck, Internal Revenue Service, 2002 EO CPE Text, p. 270-273, <http://apps.irs.gov/pub/irs-tege/eotopich02.pdf> (Accessed 1/12/09)

⁴ "Report on Exempt Organizations Executive Compensation Compliance Project – Parts I and II," By Internal Revenue Service, March 2007, p.8, http://www.irs.gov/pub/irs-tege/exec_comp_final.pdf (Accessed 1/12/09)

⁵ "IRS Issues Final Excess Benefit Rules on When Exemptions May be Threatened," BNA Health Law Reporter, April 3, 2008,

⁶ "Hospital Study to Show Executive Pay High, Much Reliance on Comparability Data," BNA's Health Law Reporter, November 20, 2008. "Details of Executive Compensation Practices Released in IRS Tax-Exempt Hospital Report," By Peyton M. Sturges and Diane Freda, BNA Health Law Reporter, Vol. 18, No. 205 (2/19/2009).

⁷ "An Introduction to I.R.C. 4958 (Intermedia Sanctions)," By Lawrence M. Brauer, Toussaint T. Tyson, Leonard J. Henzke, and Debra J. Kaweck, Internal Revenue Service, 2002 EO CPE Text, p. 270-273, <http://apps.irs.gov/pub/irs-tege/eotopich02.pdf> (Accessed 1/12/09).

⁸ "Report on Exempt Organizations Executive Compensation Compliance Project – Parts I and II," By Internal Revenue Service,

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March 2007, p.8, http://www.irs.gov/pub/irs-tege/exec_comp_final.pdf (Accessed 1/12/09).

⁹ “IRS Exempt Organizations Hospital Compliance Project Final Report,” Internal Revenue Service, February 13, 2009 pp. 132, 138.

¹⁰ “IRS Exempt Organizations (TE/GE) Hospital Compliance Project Final Report” By Internal Revenue Service

¹¹ “IRS Exempt Organizations Hospital Compliance Project Final Report,” Internal Revenue Service, February 13, 2009, pp. 127–129.

¹² “Details of Executive Compensation Practices Released in IRS Tax-Exempt Hospital Report,” By Peyton M. Sturges and Diane Freda, BNA Health Law Reporter, Vol. 18, No. 205 (2/19/2009).

¹³ “IRS Exempt Organizations Hospital Compliance Project Final Report,” Internal Revenue Service, February 13, 2009, pp. 127–129.

¹⁴ “Details of Executive Compensation Practices Released in IRS Tax-

Exempt Hospital Report,” By Peyton M. Sturges and Diane Freda, BNA Health Law Reporter, Vol. 18, No. 205 (2/19/2009).

¹⁵ “Initial Contract Exceptions – Intermediate Sanctions” By the Internal Revenue Service, <http://www.irs.gov/charities/charitable/article/0,,id=173696,00.html> (Accessed on 2/19/2009).

¹⁶ “Initial Contract Exceptions – Intermediate Sanctions” By the Internal Revenue Service, <http://www.irs.gov/charities/charitable/article/0,,id=173696,00.html> (Accessed on 2/19/2009).

¹⁷ “IRS Plans Exams to Boost Understanding of Tax-Exempt Organization’s Governance,” BNA’s Health Law Reporter, December 4, 2008



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