

IRS Prepares for New Initiative Scrutinizing Executive Compensation Arrangements

In February 2010, the Internal Revenue Service (IRS) will begin a payroll audit program of 6,000 companies, including an approximately 1,500 tax-exempt organizations, such as non-profit hospitals.¹ The program primarily focuses on the misclassification of employee status, which can cost nearly \$200 million annually in unemployment costs, and excessive executive compensation.² The latter has faced increasing national scrutiny over the last several years, most notably in tax-exempt organizations, which have been accused of squandering government and charitable aid on executive benefits. A 2006 IRS survey of tax-exempt hospitals, for example, found that the reported executive compensation provided at 20 exempt hospitals was, on average, \$1.4 million.³

Currently, the Internal Revenue Code (IRC) allows non-profit hospitals to determine executive compensation rates using a method that creates a “*rebuttable presumption*” of legitimacy to avoid IRS penalties.⁴ These provisions state that compensation paid to a *disqualified person*, one who is in a position to exert substantial influence over an organization during the time 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.⁵

Critics of the IRC section 4958 have charged the rebuttable presumption standard with shifting the burden of compliance to the government and creating a minimum, rather than a maximum threshold for executive compensation arrangements.⁶ IRS studies have shown that executive compensation at tax exempt healthcare entities is very high, yet remain in compliance with the rebuttable presumption standard. The current provision also severely limits the means by which the IRS may challenge the reasonableness of such high compensation levels, as long as the exempt entity is in compliance.⁷ The 2010 audits are part of an agency wide National Research Program (NRP) of employee tax reports, the purpose of which is to collect data to help the IRS target future employment tax audits.⁸

Additionally, companies that are found to have executive compensation plans and/or benefits exceeding FMV, according to the auditors, face strict application of the current codes sanctions. Such penalties include being subject to an excise tax and the possible revocation of an organization’s tax-exempt status.⁹ The individual receiving the compensation exceeding FMV (i.e., the recipient of an *excess benefit transaction*) must pay a 25% tax on the excess benefit and correct it with interest within the taxable period during which the excess benefit occurred.¹⁰ If the excess benefit is not corrected within the taxable year, a 200% tax is applied to the uncorrected portion of the transaction.¹¹ Additionally, the IRS can impose a 10% tax on managers of the organization who knowingly and willfully participated in the excess benefit transaction. In anticipation of the upcoming IRS audit, exempt organizations have been advised to identify any disqualified persons and determine whether the organization has complied with section 4958 regulations.¹² If the safe harbor of the rebuttable presumption is inapplicable, the company should identify written compensation benchmark data used in the determination of executive pay as a means to justify the arrangement to the IRS.¹³

In addition to the increased scrutiny of hospital executive compensation by the IRS, provisions in recently passed health care legislation will likely result in additional enforcement action taken against non-profit entities. Section 4959 of the “Patient Protection and Affordability Act” (PPAA) calls for a mandatory review of the tax-exempt status of non-profit hospitals, focusing on the adequacy of their community benefit activities,¹⁴ the standard by which hospitals gain tax-exempt status subsequent to the removal of charity care requirements in 1969.¹⁵ At the state level, Massachusetts announced increased supervision over executive compensation in charitable health care organizations on September 2, 2009.¹⁶ Similar legislation to control soaring executive compensation call for the elimination of the section 4958 safe harbor, but as of yet, nothing has been passed.¹⁷ All investigative efforts by both state and federal agencies regarding executive compensation assist the IRS with insight into the procedures for setting executive salaries at tax exempt organizations and how to regulate these practices.¹⁸

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- ¹ “Enforcement Efforts Take Aim at Executive Compensation of Tax-Exempt Health Care Entities” by Candace L. Quinn and Jeffrey D. Mamorsky, 18 Health Law Reporter 1640, Dec. 17, 2009.; “Employment Tax Audits of Exempt Hospitals Could Turn Up Other Issues, Attorneys Warn” 18 Health Law Reporter 1653, Dec. 24, 2009.
- ² “Employment Tax Audits of Exempt Hospitals Could Turn Up Other Issues, Attorneys Warn” 18 Health Law Reporter 1653, Dec. 24, 2009.
- ³ “Enforcement Efforts Take Aim at Executive Compensation of Tax-Exempt Health Care Entities” by Candace L. Quinn and Jeffrey D. Mamorsky, 18 Health Law Reporter 1640, Dec. 17, 2009; “Employment Tax Audits of Exempt Hospitals Could Turn Up Other Issues, Attorneys Warn” 18 Health Law Reporter 1653, Dec. 24, 2009.
- ⁴ “Rebuttable Presumption that a Transaction is not an Excess Benefit Transaction (Temporary)” 26 CFR 53.4958-6T, April 1, 2001, pg. 230; “An Introduction to I.R.C. 4958 (Intermediate Sanctions)” By Lawrence M. Brauer, Toussaint T. Tyson, Leonard J. Henzke, and Debra J. Kawecki, Internal Revenue Service, 2002 EO CPE Text, p. 264, <http://apps.irs.gov/pub/irs-tege/eotopich02.pdf> (Accessed 12/28/09).
- ⁵ “An Introduction to I.R.C. 4958 (Intermediate Sanctions),” By Lawrence M. Brauer, Toussaint T. Tyson, Leonard J. Henzke, and Debra J. Kawecki, Internal Revenue Service, 2002 EO CPE Text, p. 270-273, <http://apps.irs.gov/pub/irs-tege/eotopich02.pdf> (Accessed 12/28/09).
- ⁶ “Enforcement Efforts Take Aim at Executive Compensation of Tax-Exempt Health Care Entities” by Candace L. Quinn and Jeffrey D. Mamorsky, 18 Health Law Reporter 1640, Dec. 17, 2009.
- ⁷ “Enforcement Efforts Take Aim at Executive Compensation of Tax-Exempt Health Care Entities” by Candace L. Quinn and Jeffrey D. Mamorsky, 18 Health Law Reporter 1640, Dec. 17, 2009.
- ⁸ “Employment Tax Audits of Exempt Hospitals Could Turn Up Other Issues, Attorneys Warn” 18 Health Law Reporter 1653, Dec. 24, 2009.
- ⁹ “An Introduction to I.R.C. 4958 (Intermediate Sanctions)” By Lawrence M. Brauer, Toussaint T. Tyson, Leonard J. Henzke, and Debra J. Kawecki, Internal Revenue Service, 2002 EO CPE Text, p. 264, <http://apps.irs.gov/pub/irs-tege/eotopich02.pdf> (Accessed 12/28/09).
- ¹⁰ “An Introduction to I.R.C. 4958 (Intermediate Sanctions),” By Lawrence M. Brauer, Toussaint T. Tyson, Leonard J. Henzke, and Debra J. Kawecki, Internal Revenue Service, 2002 EO CPE Text, p. 275-6, <http://apps.irs.gov/pub/irs-tege/eotopich02.pdf> (Accessed 12/28/09).
- ¹¹ “An Introduction to I.R.C. 4958 (Intermediate Sanctions),” By Lawrence M. Brauer, Toussaint T. Tyson, Leonard J. Henzke, and Debra J. Kawecki, Internal Revenue Service, 2002 EO CPE Text, p. 277, <http://apps.irs.gov/pub/irs-tege/eotopich02.pdf> (Accessed 12/28/09).
- ¹² “Enforcement Efforts Take Aim at Executive Compensation of Tax-Exempt Health Care Entities” by Candace L. Quinn and Jeffrey D. Mamorsky, 18 Health Law Reporter 1640, Dec. 17, 2009.
- ¹³ “Enforcement Efforts Take Aim at Executive Compensation of Tax-Exempt Health Care Entities” by Candace L. Quinn and Jeffrey D. Mamorsky, 18 Health Law Reporter 1640, Dec. 17, 2009.
- ¹⁴ “Sec. 4959 - Taxes on Failures by Hospital Organization” from the Patient Protection and Affordability Act, p. 1967.
- ¹⁵ Revenue Ruling 69-545, 1969-2 C.B. 117, Internal Revenue Service
- ¹⁶ “Examination of Executive and Director Compensation; Increased Oversight” By David Spackman, Non-Profit Organizations / Public Charities Division, The Commonwealth of Massachusetts Office of the Attorney General, September 2, 2009, p.1.
- ¹⁷ “Enforcement Efforts Take Aim at Executive Compensation of Tax-Exempt Health Care Entities” by Candace L. Quinn and Jeffrey D. Mamorsky, 18 Health Law Reporter 1640, Dec. 17, 2009.
- ¹⁸ “Enforcement Efforts Take Aim at Executive Compensation of Tax-Exempt Health Care Entities” by Candace L. Quinn and Jeffrey D. Mamorsky, 18 Health Law Reporter 1640, Dec. 17, 2009



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