Nonprofit Executive Compensation in the Healthcare Industry: Hands-On Board Oversight and Supervision Key to Retention of Tax-Exempt Status

By James R. King, Jones Day
Columbus, Ohio

JANUARY 2006

Current Environment for Nonprofit Executive Compensation

In June 2005, Moody's Investor Services issued a “Special Comment” dealing with the extent to which good (or bad) corporate governance practices impact the credit rating of nonprofit healthcare organizations. In discussing the criteria considered in the credit rating process, the Special Comment noted that the board's handling of the “level of management compensation” for chief executive officers (CEOs) and other top management personnel in the nonprofit healthcare sector is “drawing increasing attention,” and this increased attention requires a hands-on involvement by the board in the process of establishing executive compensation and in monitoring executive performance to ensure that the organization gets the performance it has paid for.

As the Moody's Special Comment notes, nonprofit healthcare organizations today face a number of conflicting pressures regarding executive compensation. On the one hand, large healthcare organizations are complicated, sophisticated business operations that require capable, experienced management, and the organizations must compete for that talent with other comparable organizations, including for profit companies. This competition for talent results in an increased pressure to pay more to attract and retain the kinds of individuals needed to run a successful operation.

On the other hand, as the Moody's Special Comment notes, the “appropriate” level of compensation for these executives is “difficult to gauge,” and “attempts to increase executive compensation can generate negative press attention and the discontent of major constituencies.” The “major constituencies” who may become “discontented” over the level of executive compensation in the nonprofit healthcare industry can include:

- Rating agencies like Moody's which will downgrade an organization's credit rating if they find that the organization does not have adequate corporate governance and compliance measures in effect. In this case, the “discontent” can impair the organization's access to the capital markets.
- Labor unions that use allegedly excessive levels of executive compensation as leverage in organizing campaigns and collective bargaining negotiations.
- Plaintiffs lawyers who have made numerous allegations of excessive compensation and other insider financial misdeeds by healthcare organizations in various class action lawsuits alleging violations of § 501(c)(3) by nonprofit healthcare systems arising out of billing and collection practices for the uninsured.¹
- State attorneys general who investigate perceived excessive compensation paid by charitable organizations. Some of these attorneys general, most notably Attorney General Mark Hatch of Minnesota, have concluded that the compensation of many executives in nonprofit healthcare organizations is “grossly
excessive” and that boards have abused the compensation-setting process to create a “Lake Wobegon” effect, where all executives are “above average” and all are overpaid.2

• The United States Congress, particularly the Senate Finance Committee, which has responded to negative reports by the press and state attorneys general detailing real and perceived excessive compensation with investigations of its own and with a variety of proposals for reform of tax-exempt organizations, including proposals to change the legal rules governing the process used to set executive compensation for tax exempt organization executives.3

• The Internal Revenue Service (IRS), which has focused on excessive compensation issues through several current initiatives, including the Tax Exempt Compensation Enforcement Project which began in 2005 and which will continue into 2006 and beyond. Pursuant to this initiative, during 2005 the IRS mailed over 2,000 so-called “soft contact” letters to tax-exempt organizations seeking extensive information about, among other things, the types of compensation being paid, whether the compensation was set using market comparables, and whether compensation arrangements were negotiated at arms’ length by disinterested fiduciaries.4

Federal Tax Rules Impacting Nonprofit Executive Compensation

There are a number of federal tax rules that set the parameters for the level of compensation that may be paid to executives of tax-exempt organizations, the consequences of paying excessive compensation, and the process that the IRS would like to see followed in establishing, approving, and monitoring executive compensation.

Excess Benefit Transaction Rules

The most high-profile provision of the tax code that applies to executive compensation is §4958, which sets forth the rules applicable to so-called “excess benefit transactions.” In the executive compensation arena, an excess benefit transaction will occur if the organization pays a top executive more than “reasonable compensation” or if the organization and the executive engage in certain “automatic” excess benefit transactions.

Automatic excess benefit transactions include such seemingly “minor” matters as permitting the executive to have personal use of automobiles, cell phones, or other organization owned assets without proper expense reporting or income inclusion, or permitting spousal travel without including the value of that travel in the executive's taxable income. These transactions are referred to as “automatic” excess benefit transactions because, unless the items of value are properly reported on an “accountable” expense plan or currently reported as income when provided, the excess benefit rules treat the value of the executive's services provided in exchange for those benefits as zero. Thus, anything received is worth more than zero and is an “automatic” excess benefit.5

Engaging in an excess benefit transaction imposes certain excise taxes6 on the above market component of the compensation, including any automatic excess benefit component. These excess benefit transaction excise taxes are not imposed on the exempt organization itself but are instead imposed on the executives receiving the unreasonable compensation and on any officers, directors, and other “organization managers” of the organization a who knowingly participate in approving the payment of the unreasonable compensation.7

In addition, as discussed below, engaging in an excess benefit transaction requires the organization to disclose and describe the excess benefit transaction on Line 89b of its annual Form 990. This not only alerts the IRS to the problem, but because the Form 990 is a publicly available document (e.g., it is available online within minutes at www.guidestar.org), it can put the “discontented constituencies” just a few mouse clicks away from getting the details of a compliance problem at the organization. The most frequent reason to have to make a disclosure on Line 89b is the automatic excess benefit, which, even though it is usually involves a “minor” amount of money, can nonetheless create a major issue for both the executive and the organization.

Executives as “Disqualified Persons”

To be subject to these excess benefit transaction excise taxes, an executive must be a so-called “disqualified person.” In general terms, a person is a disqualified person with respect to a § 501(c)(3) organization if, at any time during the five-year period ending on the date of the transaction in question, the person was in a position to exercise substantial influence over the affairs of the organization.8
Certain key executive officers (the CEO, the COO (chief operating officer), and the CFO (chief financial officer)) are automatically deemed disqualified persons. Other top executives may be disqualified persons if they have or share the authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or employee compensation or if they manage a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income or expenses of the organization, as compared to the organization as a whole. As a result, members of the top-level management team of a tax-exempt healthcare organization are likely "disqualified persons" for excess benefit transaction purposes.

**Reasonable and Unreasonable Compensation**

As noted, it is only payment of more than "reasonable compensation" to an executive who is a disqualified person that triggers an excess benefit tax, so it is crucial to have a very solid grasp of what compensation is reasonable and what compensation is not reasonable. In addition, it is important to have an understanding of the "automatic" excess benefit rules, as they can frequently, and inadvertently, trigger the excess benefit excise taxes.

From a technical perspective, the tax law defines reasonable compensation as the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances, taking into account the aggregate benefits provided and the rate at which any deferred compensation accrues. In computing aggregate benefits provided, compensation includes all forms of cash and noncash compensation, including salary, fees, bonuses, severance payments, and deferred and noncash compensation, as well as employee benefits such as payments to welfare benefit plans, plans providing medical, dental, or life insurance, disability benefits, the economic benefit of a below-market loan, and all other benefits.

However, as the Moody's Special Comment noted, what is reasonable or not reasonable compensation for top healthcare executives is "difficult to gauge." As a result, for large, complex organizations, the board of directors usually concludes that it is best to engage the services of an independent compensation consultant to study the duties of the executive, the complexity of the organization the executive serves, the other organizations in the market that are comparable to the employer organization, and the range of compensation paid to other individuals performing comparable duties at comparable organizations. Even then, as evidenced by the "Lake Wobegon" comments of Minnesota Attorney General Hatch before the Senate Finance Committee noted above, not all regulators will accept the results of the effort to determine what is reasonable and what is not.

Moreover, due to the "automatic" excess benefit rules, organizations need to ensure that their tax compliance includes a very careful look at how expense reimbursements are handled, especially for travel and entertainment activities. Experience in responding to the IRS "soft contact" audits indicates that these items are on every IRS agent's checklist, thus failure to deal with these items properly can cause both tax problems and public embarrassment for the individuals and the organization.

**Private Inurement Rules**

Under the private inurement rules found in § 501(c)(3) of the tax code, "no part" of a § 501(c)(3) healthcare organization's net earnings may inure to the benefit of private shareholders or individuals. As interpreted by the relevant authorities, the inurement prohibition applies to all non-fair market value transactions (including unreasonable compensation) with, or transactions that otherwise are devices to distribute charitable earnings to, so-called "insiders" (persons who have an opportunity to control or influence an organization's activities because of their relationship with the organization). The definitions of "disqualified person" for excess benefit transaction purposes and "insider" for inurement purposes will always overlap. As a result, top executives will be both disqualified persons for excess benefit purposes and insiders for private inurement purposes.

Under the traditional private inurement doctrine, any amount of private inurement to insiders, regardless how small or de minimis, would, in theory, lead to revocation of an organization's tax-exempt status. Thus, unlike the excess benefit rules, which penalize the disqualified person, not the organization, the private inurement rules penalize the organization, not the insider, by causing the organization to lose its tax-exempt status. This leaves the insider, who is the "bad actor" in the drama, unpunished (except perhaps by Attorney General Hatch and his colleagues across the country), and it causes the organization to lose tax-exempt status, which hurts the charitable beneficiaries of the organization, not the individuals who caused the problem.
As a result, the traditional private inurement doctrine has been modified by the congressional intent underlying § 4958 of the code, by the current administrative policy of the IRS, and by the position taken by the IRS and the Treasury in certain proposed regulations (discussed below) dealing with the relationship among private inurement, excess benefit, and loss of tax-exempt status. Under these modifications to the traditional private inurement rules, in cases where private inurement and excess benefit overlap, the IRS will not pursue revocation of tax-exempt status, except in cases in which the violation rises to such a level as to call into question whether, on the whole, the organization functions as a tax-exempt organization. This means that in most cases, unreasonable compensation paid to top executives will be dealt with under the excess benefit rules, where the sole remedy is imposition of excise taxes, not revocation of tax-exempt status.17

**Private Inurement, Excess Benefit, and Loss of Tax-Exempt Status**

On Sept. 8, 2005, the IRS released a set of proposed regulations18 setting forth the standards the IRS proposes to use to determine whether to revoke the §501(c)(3) status of an organization that has engaged in a transaction that constitutes both (i) traditional private inurement under §501(c)(3) of the tax code, and (ii) an excess benefit transaction under the intermediate sanctions rules of §4958 of the tax code. As noted, the private inurement rules and the excess benefit transaction rules will always overlap with respect to payment of unreasonable compensation to top executives. As a result, these proposed regulations would apply to all transactions where a top executive directly or indirectly receives a non-fair market value economic benefit (either goods or services) from a § 501(c)(3) organization, including the payment of unreasonable compensation.

Under these proposed regulations, there is a direct connection between responsible corporate governance and compliance practices and continued tax exemption for the organization. Organizations that attempt in good faith to follow good corporate governance and compliance practices both before and after a private inurement problem occurs (even a big private inurement problem) will survive with their tax-exempt status intact. Those organizations that do not follow good corporate governance practices and compliance practices will lose their tax-exempt status, and the insiders involved in the problematic transactions will not only be subject to excess benefit excise tax penalties but may also lose their jobs.

In this regard, the proposed regulations are the first attempt to put into place in a formal, precedential fashion, the standard recently articulated by IRS Commissioner Everson in his May 26, 2005, testimony before the House Ways and Means Committee in its consideration of the proper standards for tax exemption for healthcare organizations. In his testimony, Commissioner Everson noted that the principal criterion the IRS looks at “to differentiate the tax-exempt hospital from a for profit operation” is whether the hospital has an “independent board exercising its fiduciary duty to operate for the benefit of the community.”

In making the determination as to whether or not to seek revocation of tax-exempt status, the proposed regulations provide that the IRS will consider all relevant facts and circumstances, including, but not limited to, the following:

1. The size and scope of the organization's regular and ongoing activities that further exempt purposes before and after the excess benefit transaction or transactions occurred;
2. The size and scope of the excess benefit transaction or transactions (collectively, if more than one) in relation to the size and scope of the organization's regular and ongoing activities that further exempt purposes;
3. Whether the organization has been involved in repeated excess benefit transactions;
4. Whether the organization has implemented safeguards that are reasonably calculated to prevent future violations; and
5. Whether the excess benefit transaction has been “corrected” (that is, whether the excess benefit has been repaid, plus interest), or the organization has made good faith efforts to seek correction from the insiders who benefited from the excess benefit transaction.19

All of the foregoing factors will be considered in combination with each other, and depending on the particular situation, the IRS may assign greater or lesser weight to some factors than to others. Factors 4 and 5 will weigh more strongly in favor of continuing to recognize exemption where the organization discovers the excess benefit
transaction or transactions and takes action before the IRS discovers the excess benefit transaction or transactions. Further, with respect to Factor 3, correction after the excess benefit transaction or transactions are discovered by the IRS is never, standing alone, a sufficient basis for continuing to recognize exemption.

The proposed regulations make it clear that de minimis amounts of private inurement will not result in loss of tax-exempt status if the inurement was inadvertent and if the organization acted reasonably before and after the problem was discovered. This marks a dramatic, and positive, change from the old, draconian notion that the “no part” of the “net earnings” language of §501(c)(3) meant that any amount of private inurement, however small or unintended, would lead to loss of tax-exempt status. The proposed regulations get rid of this old, largely unworkable, idea and replace it with a more common sense, practical approach.

The proposed regulations also make it clear that substantial private inurement will not result in revocation of tax-exempt status if, after discovery of the problem, and before the IRS raises the issue on audit, the organization takes whatever steps it can (i) to correct its prior sins and (ii) to put in place policies and procedures reasonably designed to prevent a reoccurrence of the problem. Those steps include, where appropriate:

• Firing the top executive who participated in the private inurement/excess benefit transaction.
• Appointing new, disinterested fiduciaries who will be mindful of their duties to perform due diligence and to avoid conflicts of interest.
• Taking aggressive action to recover any unreasonable compensation paid to top executives, including filing lawsuits where necessary.
• Taking reasonable steps to put in place policies and procedures designed to prevent problems in the future.

In short, there is an emphasis throughout the proposed regulations on accountability. This nexus between accountability and tax-exemption will make it more likely that, in order to maintain tax-exempt status, boards will have to act to fire top executives who are responsible for bad conduct, either by participating in the bad conduct directly or by sloppy supervision of others who get in trouble. The proposed regulations also make it clear that an all-too-common tendency to let the past slide and to fix things on a going forward basis only is no longer acceptable, if it ever was. In order to preserve tax-exempt status, the proposed regulations suggest that the IRS will insist that the organization clean up the existing mess as part of the steps necessary to retain tax-exempt status, including taking legal action to sue the executive to recover any unreasonable compensation paid if voluntary repayment cannot be arranged. Finally, the proposed regulations strongly suggest that, as part of the price to be paid to maintain exempt status, the IRS will frequently require board members who did not supervise management properly to step aside in favor of board members who will perform due diligence and who will properly supervise management.

IRS “Corporate Governance” Standards

While there have been a variety of suggestions for reform and for statutory “corporate governance” rules for tax-exempt organizations, the IRS does not currently have express statutory authority to require any particular corporate governance practices relating to setting and monitoring executive compensation. Nevertheless, using (i) the “independent board” criterion of the community benefit standard found in Revenue Ruling 69-545, the standard for exemption for healthcare organizations, (ii) certain optional provisions of the excess benefit tax rules creating a so-called “rebuttable presumption process,” and (iii) its power to promulgate tax forms and to require organizations to disclose on those forms compensation-related data and also the extent to which the organization has complied with the IRS view of “best practices,” the IRS has managed to cobble together a very effective set of “best practices” for the corporate oversight of the compensation setting process for top executives.

Substantial Conflicts of Interest Policy

The first leg of the IRS best practices triad is the adoption of a “substantial” conflicts of interest policy. In the FY 1997 CPE Text, the IRS published an article by Lawrence Brauer and Charles Kiaser of the IRS National Office, entitled “Tax-Exempt Healthcare Organizations Community Board and Conflict of Interest Policies,” which sets forth...
the IRS view that all healthcare organizations must have a “community board” comprised of a majority of members who do not have any significant financial relationship with the organization and that this community (independent) board must adopt and operate pursuant to a “substantial” conflicts of interest policy containing the provisions found in a Sample, which was included as part of the CPE Text article.

The FY 1997 CPE Text article explains that the purpose of a conflicts of interest policy is to protect the organization's interest in insider transactions. Such a policy provides the board with the ability to make objective decisions without potential undue influence by persons with private interests, and it helps to ensure that an organization fulfills its charitable purposes, properly oversees its directors’ activities, and pays reasonable compensation to its executives and other employees. According to the IRS, a substantial conflict of interest policy must include at least the following basic provisions:

• Disclosure by interested persons of financial interests and related material facts.
• Specific procedures for determining whether the interested person's financial interest may result in a conflict of interest.
• Procedures for addressing any conflicts of interest that are found.
• A requirement that any interested person leave the meeting during discussion and voting on the conflicted transaction.
• The ability to appoint a disinterested person or committee to investigate alternatives to the proposed transaction in question.
• A determination by majority vote of the disinterested members present that the transaction was in the organization's best interests and for its own benefit; that the transaction was reasonable; and, after exercising due diligence, that the organization cannot obtain a more beneficial transaction with reasonable efforts under the circumstances.
• The authority to take appropriate disciplinary action against any interested person who violates the conflicts of interest policy.

Rebuttable Presumption of Reasonableness

The second component of the IRS “best practices” regime is the rebuttable presumption of reasonableness process, which, as discussed below, is an optional process that organizations can use to establish a “rebuttable presumption” that any compensation set using the process is reasonable. Three conditions must be met in order to trigger the rebuttable presumption.

1. Use a Disinterested “Authorized Body” to Review Compensation

There are two requirements under this criterion, (i) the compensation arrangement for an executive must be approved in advance by an “authorized body” of the organization, and (ii) the “authorized body” must be composed entirely of individuals who do not have a “conflict of interest” with respect to the compensation transaction being reviewed.

There are three categories of authorized bodies whose approval of a transaction satisfies the first condition required to trigger the rebuttable presumption. Those bodies are (i) the governing body of the organization, (ii) a committee of that governing body, and (iii) to the extent permitted under state law, other parties authorized by the governing body to act on its behalf by following specified procedures in approving compensation arrangements or property transfers. These alternatives give organizations a significant amount of flexibility to establish a structure that works best for that organization, and frequently organizations will have different approval bodies for different categories of employees within an organization. Usually, the compensation approval process is controlled by a Compensation Committee consisting of independent directors who have some combination of financial sophistication and industry knowledge regarding compensation norms.
A person is considered not to have a conflict of interest if all of the following five requirements are met: (i) the person is not a disqualified person participating in or economically benefiting from the compensation arrangement and is not a member of the family of any such disqualified person, (ii) the person is not in an employment relationship subject to the direction or control of any such disqualified person, (iii) the person does not receive compensation or other payment subject to approval by any such disqualified person, (iv) the person has no material financial interest affected by the compensation arrangement, and (v) the person does not approve a transaction providing economic benefits to any disqualified person participating in the compensation arrangement or property transfer, who in turn has approved or will approve a transaction providing economic benefits to the person. 29

2. Base Compensation on “Appropriate Data as to Comparability”

The authorized body must have obtained and relied upon appropriate data as to comparability, prior to making its compensation determination. 30 In general, 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 the compensation arrangement is reasonable. 31 When determining whether the data on which the authorized body relied in rendering its conclusion of comparability is appropriate, both the type of data examined and the expertise of the members of the authorized body are important. 32 Generic surveys do not provide appropriate data if the members of the authorized body lack the experience and expertise to extrapolate the relevant material from the surveys and apply it to the transaction being reviewed. 33 On the other hand, custom surveys tailored to the specific transaction in question will be appropriate data as to comparability. 34 Moreover, an opportunity to question experts familiar with the market and the transaction being reviewed can serve to cure any lack of experience and expertise on the part of an authorized body. 35

As discussed above, for large, complex organizations, the board usually concludes that it is best to engage the services of an independent compensation consultant to advise the authorized body on comparability issues. In retaining a compensation consultant, it is important that the “authorized body,” whether the board or a committee, retain the consultant and that the consultant report directly to the authorized body, not to the executive. Neither the IRS nor a skeptical attorney general worried about the “Lake Wobegon” effect will consider a consultant retained by the member of the executive team whose compensation is under review to be independent. Such a consultant will be considered to have a conflict of interest and to have loyalties that run to the executive, not the board. Furthermore, while it is perfectly appropriate for the executives to make a pitch for why they have made important contributions to the organization and, therefore, deserve to be paid at a certain level, both the IRS and the attorneys general are on the alert for executives who try to “back door” the process and exert undue influence behind the scenes. Indeed, all of the IRS “soft contact” audits make specific inquiry into whether there has been any effort by an executive to improperly influence the process.

3. Adequately and Contemporaneously Record the Basis for the Compensation Decision

The authorized body must adequately document the basis for its determination concurrently with making that determination. 36 In order for a comparability decision to be adequately documented, the written or electronic records of the authorized body must include the following: (i) the terms of the approved transaction and the date on which the transaction was approved, (ii) the members of the authorized body who were present during debate regarding the approved transaction and the members who voted on matter under consideration, (iii) the comparability data obtained and relied upon by the authorized body and how that data was obtained, and (iv) 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. 37

A decision is deemed concurrently documented when (i) records are prepared before the latter of the next meeting of the authorized body or 60 days after the final action of the authorized body is taken and (ii) records have been reviewed and approved by the authorized body as reasonable, accurate and complete within a reasonable time period thereafter. If the authorized body determines that a specific compensation arrangement is higher or lower than the range of comparability data obtained, the authorized body must record the basis for its determination. 38

This is a purely mechanical provision, and organizations should not merely comply with the minimum standards set forth in the regulations but should go beyond and “tell the whole story” in substantial detail. However, even though compliance with this criterion should be a no brainer, experience in representing organizations in the soft contact audit process indicate that far too many organizations are committing unforced errors in adequate documentation of
the process used. All too frequently, many organizations cite a concern for confidentiality regarding compensation arrangements for their failure to comply fully with these requirements. This arises out of the erroneous assumption that all of the support data must appear in the organization's minute books, which in many instances may be available to a fairly wide audience within the organization. There is no requirement to place all the confidential information in a widely available minute book. The rules only require that the “written or electronic records” contain the information, and these records can be maintained in a secure, confidential manner.

**Importance of Triggering the Presumption**

Putting forth a genuine, good faith effort to trigger the presumption carries with it two principal benefits for the organization and the executives involved.

First, under the federal tax laws, taxpayers are generally considered to be guilty unless they prove themselves innocent. Triggering the presumption reverses that burden of proof with respect to whether the compensation is reasonable or unreasonable. If the presumption is triggered, any payments made under the approved compensation arrangement are presumed to be reasonable, and this presumption may only be rebutted if the IRS develops sufficient contrary evidence to rebut the probative value of the comparability data upon which the authorized body relied.

Second, even if the organization fails to trigger the presumption, the failure to trigger the presumption does not create any inference that the transaction is an excess benefit transaction, and a good faith effort to trigger the presumption almost certainly establishes “reasonable cause,” which is defined as the exercise of ordinary business care and prudence. A determination of “reasonable cause” is important because it will help protect the organization’s tax-exempt status under the proposed regulations discussed above and because it will likely enable the executives involved to obtain abatement of any excess benefit penalties imposed.

Thus, organizations should attempt to put in place as many of the rebuttable presumption conditions as possible.

**Form 990 Disclosure Obligations Regarding Compensation Matters**

The third and final link in the IRS’s corporate governance chain is the IRS’s use of Form 990, the exempt organization tax return, to increase transparency regarding corporate governance and compensation practices by requiring increasing amounts of disclosure about compensation matters and the process used to approve compensation. This information is used by the IRS to identify problematic circumstances that should be targeted for audit. In addition, because Form 990 is a publicly available document, the information contained in these disclosures is available to the other “discontented constituencies” discussed above. This transparency, and the fear of misdeeds appearing on the front page of The Washington Post or The Wall Street Journal as a result of disclosure on Form 990 is a powerful weapon for the IRS in encouraging good corporate governance and tax law compliance.

**Current Form 990 Disclosure Obligations**

Currently, Form 990 contains several provisions requiring an exempt organization to disclose financial transactions with top executives and other insiders, including an obligation to disclose the following:

- Whether the organization has directly or indirectly engaged in any financial transactions with any key employees, or members of their families, or with any taxable organization with which the key employee is affiliated as an officer, director, trustee, majority owner, or principal beneficiary. The financial transactions involved include sales and exchanges of property, loans or other extensions of credit, furnishing of goods, services, or facilities, payment of compensation (or reimbursement of expenses of more than $1,000), or any other transfer of income or assets.

- Whether during the year covered by the current return the organization engaged in any excess benefit transaction, or whether during that year the organization became aware that it had engaged in an excess benefit transaction in any prior year. If so, the organization is required to described the excess benefit transaction, the persons involved, whether the transaction was corrected, and what steps the organization has taken to ensure that excess benefit transactions do not occur in the future.
• Whether there are family or business relationships among highly compensated employees and independent contractors and board members or their families.  

• Whether the organization pays any compensation or benefits to former officers, directors, trustees, or key employees and, if so, what compensation and benefits are paid.

**Probable Future Form 990 “Best Practice” Disclosure Obligations**

The process of requiring expanded disclosure on Form 990 is continuing, and IRS officials say that the kinds of disclosure now seen on Form 1023, the form used to apply for recognition of § 501(c)(3) status, will find their way into Form 990 over the next several years. Most importantly, Form 1023 requires organizations to “check the box” as to whether or not the organization complies with what are described as “best practices” regarding the process used to review and approve compensation. If the organization, checks a “no” box as to a particular “best practice,” the organization is then, in effect, required to describe the process it does use and to explain why and how that process arrives at the same result as the “best practice.”

Based on the current Form 1023, the “best practices” likely to appear on Form 990 in the near future will include disclosures as to whether the organizations attempted to trigger the rebuttable presumption and whether it has and follows a substantial conflict of interest policy, including the following “best practices”:

• Approving compensation arrangements in advance of the performance of services and payment of compensation.

• Documenting on a contemporaneous basis the date and terms of approved compensation arrangements.

• Recording in writing the decision made by each individual who decided or voted on compensation arrangements.

• Approving compensation arrangements based on information about compensation paid by similarly situated taxable or tax-exempt organizations for similar services, current compensation surveys compiled by independent firms, or actual written offers from similarly situated organizations.

• Recording in writing both the information relied upon in arriving at compensation decisions and the source of that information.

In addition to seeking information on the process used to set compensation, Form 990 will also likely seek information about the structure of compensation arrangements, including whether insiders are compensated through nonfixed payments, such as discretionary bonuses or revenue-based payments. If such arrangements are used, the organization will be required to describe all nonfixed compensation arrangements, including how the amounts are determined, who is eligible for such arrangements, whether there is a “cap” on total compensation, and how the organization determines that it is not paying more than reasonable compensation for services.

In this context, a “fixed payment” refers to a payment that is either a set dollar amount or that is fixed through a specific formula where the amount does not depend on discretion. For example, a base salary of $200,000 that is adjusted annually based on the increase in the Consumer Price Index is a fixed payment. A nonfixed payment is a payment that depends on discretion. For example, a bonus of up to $100,000 that is based on a performance evaluation by the governing board is a nonfixed payment because the governing board has discretion over whether the bonus is paid and the amount of the bonus.

Where any of the foregoing transactions are evidenced by written agreements, there will likely be a requirement to produce copies of those agreements, and where there are oral arrangements, not evidenced by written documentation, there will likely be a requirement to identify those oral arrangements, to specify the terms and conditions of those arrangements and to describe the process used to establish the arrangements and to ensure that the arrangements are on fair market value terms and conditions and were negotiated on an arms’ length basis.

**Conclusions and Recommendations**

Attracting and retaining high quality talent is crucial for success in the highly competitive and highly regulated...
healthcare industry. Moreover, as the Moody's Special Comment indicates, determining the proper level of compensation is a difficult process and one that, under the current IRS rules, requires the hands-on involvement of the board of the organization. In exercising that close and direct supervision of the compensation process, boards should be sure that (i) all board members are educated about, and understand, the IRS “best practices” for corporate governance, and (ii) that the organization adopts policies, procedures, and practices that keep the organization in compliance with the IRS’s version of “best practices.” Board members should also be aware of the downsides to failure to comply with those “best practices,” including suffering the personal and institutional negative consequences that can arise from the “discontent of major constituencies” of today's tax-exempt healthcare organizations.

Footnotes

1 See generally, King & Blais, Nonprofit Hospital Billing Litigation Highlights Fundamentals of Section 501(c)(3), 17 TAXATION OF EXEMPTS 24 (July/August 2005).


3 For example, the WASHINGTON POST articles on The Nature Conservancy and its dealings with Conservancy insiders, and on American University and its contract troubles with its former President, Benjamin Ladner, both led to investigations by the Senate Finance Committee and, most likely, the IRS. In the case of American University, the press reports caused Senator Grassley, in a letter to the Acting Board Chair, to label the board's handling of compensation matters for former President Benjamin Ladner, a "poster child" for the need for reform of nonprofit corporate governance.


6 For disqualified persons, the tax is equal to 25 percent of the excess benefit received, with an additional 200 percent tax imposed if the disqualified person does not timely “correct” the excess benefit transaction. Correction is a rescission-type remedy that requires the return of the excess benefit, plus interest. For organization managers, the tax is equal to 10 percent of the excess benefit (capped at $10,000 per transaction).

7 I.R.C. § 4958(a); Treas. Reg. § 53.4958-1(a).

8 I.R.C. § 4958(f)(1); Treas. Reg. § 53.4958-3(a)(1).

9 Treas. Reg. § 53.4958-3(c)(1), (2), and (3).

10 Treas. Reg. §53.4958-3(e)(2)(iv) and Treas. Reg. §53.4958-3(g), Examples 7-10, 11.

11 Treas. Reg. §53.4958-3(e)(2)(v) and Treas. Reg. §53.4958-3(g), Example 8.


14 Treas. Reg. § 1.501(c)(3)-1(c)(2).

15 Treas. Reg. § 1.501(a)-1(c); United Cancer Council Inc. v. Commissioner, 165 F.3d 1173, 1176, 4 EXC 1 (7th Cir. 1999); American Campaign Academy v. Commissioner, 92 T. C. 1053, 3 EXC 32 (1989).


18 These proposed regulations were published in the Federal Register on Sept. 9, 2005, at 70 Fed. Reg. 53,599-53,604.


27 Treas. Reg. §53.4958-6(a)(1).
28 Treas. Reg. §53.4958-6(c)(1)(i)(A), (B), and (C).
29 Treas. Reg. §53.4958-6(c)(1)(ii)(A), (B), (C), (D), and (E).
30 Treas. Reg. §53.4958-6(a)(2).
31 Treas. Reg. §53.4958-6(c)(2)(i).
32 Treas. Reg. §53.4958-6(c)(2)(iv), Examples 1-3; TAM 200244028 (June 21, 2002). In TAM 200244028, the IRS concluded that the applicable tax-exempt organization met the first condition (consideration by an authorized body without a conflict of interest) and third condition (adequate and concurrent documentation) for triggering the presumption but held that the organization did not meet the second condition (consideration of appropriate data as to comparability). The IRS focused on the lack of expertise of the members of the authorized body, the failure of the body to rely on any compensation analysis concurrently with making its decision, the stale nature of certain data that may have been considered, and the particular services to be rendered by each disqualified person.
33 Treas. Reg. §53.4958-6(c)(2)(iv), Example 1.
34 Treas. Reg. §53.4958-6(c)(2)(iv), Examples 2 and 3.
35 Treas. Reg. §53.4958-6, Example 3.
36 Treas. Reg. §53.4958-6(a)(3).
37 Treas. Reg. §53.4958-6(c)(3)(i)(A), (B), (C), and (D).
38 Id.
39 Treas. Reg. §53.4958-6(a).
40 Treas. Reg. §53.4958-6(b).
41 Treas. Reg. §53.4958-6(e).

43 To encourage correction, the intermediate sanctions rules provide disqualified persons with an opportunity to have both the first-tier and the second-tier excise taxes abated. Before abatement of the first-tier tax is granted, however, there must be timely correction and the disqualified person must establish, to the satisfaction of the IRS, that the disqualified person’s participation in the excess benefit transaction was due to reasonable cause and not due to willful neglect. The second-tier tax will be abated automatically if the disqualified person corrects the transaction in a timely manner. I.R.C. § 4961(a).

44 Form 990, Schedule A, Part III, Question 2.

45 Form 990, Line 89b
46 Form 990, Part V-A, Question 75a – 75c
47 Form 990, Part V-B
48 With respect to the foregoing speculations on items to be drawn from the current Form 1023, see Part V of the current Form 1023 and the accompanying Instructions for Part V.