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**Executive Compensation**

## IRS Issues Executive Compensation Initiative Report

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On March 1, 2007, the Internal Revenue Service issued its long-awaited report on the Executive Compensation Initiative launched in 2004. In addition to finding ''significant reporting errors and omissions'' by tax-exempt organizations in the areas of excess benefit transactions, lack of disclosure of transactions with disqualified persons, and loans to officers, the report provides extensive insight into how the IRS targets organizations for compliance checks and selects those it audits.[1]

Perhaps most important for nonprofit health care organizations and their counsel, the report serves as a reminder that exempt organizations may need to review their compensation policies, maintain an appropriate degree of board oversight, as well as ensure that compensation decisions are based on adequate market data on comparability and thoroughly documented. It also exposes the kind of problems that have led to an increase in pressure for voluntary adoption of corporate governance reforms in the nonprofit sector.

[1] The full report is available online at: http://op.bna.com/hl.nsf/r?Open=psts-6yvmjw.

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In studying the nonprofit executive compensation issue, the IRS used two different approaches in contacting 1,826 exempt organizations, including 1,428 public charities and 398 private foundations. Part I of the project involved sending compliance check letters to 1223 exempt organizations. Part II consisted of correspondence examinations of 782 exempt organizations (including 179 that resulted from responses to the compliance check letter, 25 of which were private foundations). Although the public charities included a variety of industries (among them health care, higher education, grant-making foundations and service organizations), neither the public charity nor private foundation participants were selected as statistically valid samples.

Despite the limitations of the sampling methodology, the project provides valuable insights into where the service found persistent reporting problems involving executive compensation, how future examinations will be conducted, and where the IRS may focus future executive compensation reviews. Although in large part the project was a learning exercise for the IRS, it also laid the groundwork for more active enforcement of Section 4958 of the Code (which imposes an excise tax of up to 225% of the amount above fair market value received by ''disqualified persons'' and 10% or $20,000 on organization managers who approve the transactions).[2]

This initiative is one of many recent attempts by the IRS to reach more exempt organizations in an educa-

[2] 26 U.S.C. § 4958. ''Disqualified persons'' include voting directors, officers, certain other influential individuals and entities, family members and 35% controlled entities.

tion and examination scenario with fewer resources. As with audits generally, it is worth noting that there is a significant lag time among the years reviewed, the time of the review, and the date on which the review is finished and the findings are released. Although the report on the Executive Compensation Initiative was only recently released, the tax year under review for most organizations was 2002. To some extent, subsequent changes in Form 990 may have reduced the reporting and other problems identified in the Executive Compensation Initiative. The continued focus on transparency in the nonprofit sector on a state and federal level, however, suggests that exempt organizations and their advisors need to pay close attention to the IRS findings in this area and move proactively to correct similar potential problems in their organizations and clients.

## Overview of Soft Contact Letters

The report is the culmination of a project that was launched with the mailing of "soft contact" letters to the exempt organization community in March and April 2005. Organizations that received these "soft contact" letters were asked to demonstrate that they have developed compensation programs which comply with IRS guidelines for establishing overall reasonable compensation to executives, board members and others, including whether the organization endeavored to establish the rebuttable presumption of reasonableness for executive compensation as outlined in the Section 4958 regulations. If an organization had not taken steps to establish a "rebuttable presumption" of reasonableness of compensation, it was asked to provide documentation supporting the fair market value of compensation for these individuals. The letters also asked for other information on how compensation was reported, conflicts of interest and certain other transactions with the identified executives, directors and officers (including loans and use of organization property). Although failure to follow the "rebuttable presumption" procedure does not itself result in tax liability or jeopardize exemption under Section 53.4958-6(e) of the regulations, based on comments from IRS officials, following that procedure for relationships with disqualified persons is viewed by the IRS as a best practice.

In interpreting the results of the Executive Compensation Initiative, it is important to understand one key difference between Part I and Part II of the project. A compliance check letter (used in Part I) is sent to an organization when the return is missing information in particular categories that warrant follow-up (e.g., failing to respond to Question 89.b. on Form 990 about whether the organization was involved in an excess benefit transaction). Compliance check letters are clearly identified as such. They are not themselves examinations, though they may lead to examinations (as happened in this project). That is an important distinction for Section 4958 purposes for organizations that may have failed to properly report compensation on Form 990 or other tax forms. In that regard, the Section 4958 regulations allow the organization to avoid treatment of unreported payments as *per se* excess benefits by reporting those payments as compensation on an amended return filed before the IRS begins an examination of the organization or the disqualified person for the relevant tax year.[3]

By contrast, a correspondence examination of the exempt organization ends the time available for amending returns to avoid a *per se* excess benefit. The correspondence examinations on executive compensation were initiated with a narrow focus; however, there is no prohibition on the IRS deciding to expand the scope of the correspondence examination to include other issues, perhaps based on the information provided (or not provided) in response to the initial questions. Compliance checks also can turn into examinations, as happened to 179 organizations in the Executive Compensation Initiative.

## Significant Findings

The findings in the report on the Executive Compensation Initiative are instructive as to future areas of inquiry by the IRS, whether in the course of audits initiated by the IRS of its own accord or with the assistance of whistleblowers. Early reactions from Congress also suggest that the areas of concern identified in the report may be the focus of further Congressional hearings if not legislation. In a press release issued the same day as the report, Sen. Max Baucus (D-Mont.) noted that he was "deeply concerned by this report of serious errors in executive compensation reporting by a number of charities." After acknowledging the positive role played by many charities, he noted that to the extent that "the reporting errors were caused by confusing paperwork, that should be fixed immediately. But as Chairman of the Finance Committee, I am committed to pursuing abuse in this sector where so much good is otherwise done."[4] Sen. Charles Grassley's (R-Iowa) comments were similar and more pointed, citing the "champagne lifestyles of certain non-profit executives."[5] He called on the IRS to revisit existing guidance and regulations governing executive compensation in the nonprofit sector and said the IRS Chief Counsel should brief the Senate Finance Committee on the steps being taken to address the problems identified in the report.

***Reporting Errors.*** Of the 1223 organizations receiving compliance check letters, it is noteworthy that approximately 30% resulted in some change in Form 990 reporting and 15% led to separate examinations (i.e., audits). Of the 782 total examinations (including 179 cases that were started as compliance checks), 10% of those remained open when the report was completed. It seems likely that the open cases will result in some change, potentially including changes in compensation processes and reporting practices and potentially assessment of excise taxes for excess benefits. Of the 782 examinations initiated, only 156 were closed on review of the file before contacting the organization. A majority of cases (434) were closed with no change after contact was made; however, a significant number (115) were closed with written directions for changes in reporting procedures and have been targeted for follow-up reviews. Another 77 cases remain open.

The reporting problems on compensation varied, with organizations reporting correctly on one form

[3] *See* 26 C.F.R. § 53.4958-4(c)(3)(i)(A)(1).

[4] Sen. Baucus' press release is available online at http://finance.senate.gov/press/Bpress/2007press/prb030107.pdf.

[5] Sen. Grassley's press release is available online at http://finance.senate.gov/press/Gpress/2007/prg030107.pdf.

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(e.g., 990) but not another (e.g., W-2). The error rates were 15% on Form 990, 13% on Form 941 (employer's return), and 15% on Form W-2. The report also notes that 50 public charities reviewed reporting compensation to one or more insiders in excess of $250,000 failed to include the required schedule on Form 990 describing the compensation. Of those 50, 41 organizations included the required information in the amended return but the other nine were referred for examination.

***Rebuttable Presumption Procedure.*** It has been regarded by many governance experts and tax advisors to be a ''best practice'' to follow the rebuttable presumption review process when approving compensation for anyone who may be a disqualified person. Following that process requires advance review and approval of the compensation arrangement by an independent board or committee, including full disclosure and approval of all terms based on comparable data for fair market value, with the decision properly and timely documented in full in the minutes.[6] Following that process establishes a rebuttable presumption of reasonableness of the compensation arrangement for all parties, and protects organizations' managers from the 10% excise tax under Section 4958.[7]

It is somewhat surprising, given the focus on corporate responsibility, that only 51% of the organizations attempted to follow all prongs for establishing the rebuttable presumption, and that only 54% of organizations obtained outside evidence of comparability (e.g., published surveys, compensation consultant reports, etc.). There may be several explanations for the lack of more widespread adoption of the rebuttable presumption procedure. A number of smaller organizations may not have had enough independent directors to be able to meet the independent approval requirement. Organizations with relatively modest pay scales may not be persuaded of the benefit of following the rebuttable presumption procedure; however, the only slightly higher percentage of organizations maintaining comparability data (54%) may suggest a more general unfamiliarity with or even affirmative disregard of the rebuttable presumption procedure. On the other hand, it also could reflect an unwillingness to pay for outside surveys or lack of awareness as to more cost effective options for obtaining comparable data (e.g., published salary surveys instead of custom compensation consultant opinions for more modest pay scales). Whatever the real reason for the lower than expected level of adoption of the rebuttable presumption procedure, the number of organizations not following that procedure led the IRS to note a need for increased education of the exempt organizations community about why and how to establish the rebuttable presumption of reasonableness, and to suggest that future examinations should focus on the correlation between following that process and avoiding excessive compensation.

Even more noteworthy, though small in scope, is that 3% of the organizations obtaining comparability data paid amounts that went beyond the comparability data. Although the regulations allow for that possibility with independent review,[8] those transactions are virtually certain to draw much closer scrutiny on audit. Finally, although 95% of insiders recused themselves from discussions and approval of their own compensation, 5% did not. Although voting on one's own compensation or even participating in the discussions does not necessarily result in an excess benefit, it too draws much closer scrutiny on audit. Both of these variances are also likely to draw attention from state attorneys general in state tax and fiduciary duty actions.

***Playing Audit Roulette.*** A frequent question in the tax area is how organizations are selected for audit. The report provides a unique insight into the IRS' selection criteria for both phases of this project, though the IRS acknowledges that the organizations receiving the various soft contact letters were not a statistically valid sample (and thus the results may not bear out as true exempt sector averages). Targeted organizations for compliance check letters included: organizations with compensation reporting that was incomplete on the face of the Form 990 (50 charitable organizations with revenues in excess of $5 million and paying ''significant'' compensation); organizations providing loans to insiders (100); organizations that answered ''yes'' or left blank Form 990 Q. 89.b. about excess benefit transactions (378) or failed to answer questions about transactions with insiders (497); and private foundations that failed to report any compensation for officers (188). Within each of those categories, the actual recipients of the letters were selected based on ''available information and likelihood of issues on the return.''[9] The IRS acknowledged varied results from these selection criteria and indicated that the criteria will be refined based on the results of the project. These criteria are still useful as indicators of potential audit triggers, though they are by no means static or exclusive. For example, based on the number of private foundations referred for Part II (correspondence examination), 25 of 188, it seems likely that the IRS also would include in future reviews any Section 501(c)(3) exempt organization with similar risk factors – i.e., failure to report any compensation for officers, employees or independent contractors.

Targeted organizations for examinations (essentially correspondence audits) consisted of two waves. The initial wave of 603 were comprised of small charities with revenues under $5 million that reported significant compensation (100), larger charities also reporting significant compensation (208), private foundations reporting significant officer compensation (198), and a random sample of charities (97). The second wave consisted of 179 organizations referred for an examination based on the responses (or lack thereof) to compliance check letters. These selection criteria for examination suggest two key lessons. First, there was a significantly higher incidence of assessment of excise taxes against private foundations related to compensation (approximately 75% of the total assessments involved private foundations despite those organizations representing only 223 of 782, or approximately 28.5%, of the organizations selected for the Part II examination phase). Private foundations were selected based strictly on high levels of compensation. This suggests that the IRS may explore the efficacy of using dollar amount screens and formulas (e.g., compensation as a percentage of revenues or expenses) to select future executive compensation audit targets. Second, although IRS compliance check letters are not audits, they must be taken seriously and answered with care and diligence. Failure to

[6] 26 C.F.R. §§ 53.4958-6(a) & (c).
[7] 26 C.F.R. §§ §§ 53.4958-1(d)(4)(iv) & 53.4958-6(f).
[8] 26 C.F.R. § 53.4958-6(c)(3)(ii).

[9] Report, p. 3, n. 2.

provide complete information or adequately explain responses can easily lead to an examination of the organization.

***Excessive Compensation Amounts.*** The most prevalent problem discovered by the IRS was a failure to correctly and fully report compensation as required on Form 990. Failure to properly report, however, can lead to automatic excess benefits (absent clear pre-audit intent to treat payments as compensation), and potential penalties for filing a false or fraudulent tax return. There were also apparent instances of excessive compensation and considerable concern over insider loans. In that regard, the report indicates that the project resulted in excise tax assessments in 25 examinations for total amounts in excess of $21 million against 40 disqualified persons and organization managers. Although the IRS stressed that the project was not based on a statistically valid sample, detractors of the nonprofit health care sector may be distressed to note that a total of only $4 million of the excise tax assessments were for any of the 559 public charities examined, including health care organizations. That relatively low incidence of assessment suggests that among the health care organizations reviewed in this project, the vast majority were able to support the compensation levels paid to top executives. The IRS, however, is likely to refine its approach to executive compensation reviews in the future to focus on organizations' exhibiting characteristics common to those organizations that did have arrangements subjected to the Section 4958 excise taxes in the Executive Compensation Initiative.

Reading between the lines, it appears that the cases resulting in assessments (and thus likely targets for future audits) generally were ones where the organization lacked adequate supporting documentation for comparable pay packages in the market and/or failed to follow the rebuttable presumption review process. These reporting and compensation problems appear to be significant enough that the IRS is likely to continue and expand the executive compensation initiative to include other organizations and potentially other employees and contractors. However, as part of the refinement of its processes, the IRS suggests that in addition to refining the questions, future examinations may be coupled with an initial in-person contact to help weed out weaker cases. Organizations that find and fix potential problems beforehand may avoid the more serious penalties and may be able to obtain some relief from at least a portion of the excise taxes.

***Internal Reviews and Corrections.*** It is significant that only 11% of excess benefit transactions among public charities were self-disclosed in advance of contact by IRS agents for an examination, suggesting that there may be room for more proactive excess benefit compliance reviews in the industry. In that regard, the IRS concluded its report with the following clear and direct caution: ''The relatively small percentage of corrections made by disqualified persons before contact by EO illustrates the need for a continued enforcement presence in this area. EO should continue to review compensation issues in more focused projects and should pursue baselining general compliance with the compensation rules.''

Organizations wishing to avoid assessments in future audits or simply seeking to verify the soundness of their compensation practices from a tax-exemption and excess benefit perspective can find useful guidance in the report and soft contact letters on how to structure an internal review. It may be prudent to conduct that review under the attorney-client privilege, recognizing that the organization may elect to waive the privilege at some future date (e.g., to use the results of the review in defense of an audit).

At a minimum, any review should include a comprehensive look at how compensation is tracked and reported, and the adequacy of comparable data to support compensation levels of potential disqualified persons. The review could include only those individuals who are deemed to be disqualified persons in the regulations (i.e., voting members of the board, and top officers such as the President, CEO, COO, CFO and Treasurer and their family members and 35% controlled entities).[10] A more thorough review would include an initial step of identifying other potential disqualified persons to include in the review, such as key employees and key medical staff members (including but not necessarily limited to those individuals and entities required to be reported on Schedule A to Form 990 as among the five highest paid employees or contractors).

The substantive areas to be covered in any such internal review should include a review for the same types of potential executive compensation problems that led to the $21 million of assessments in the Executive Compensation Initiative, including: (1) potentially excessive compensation and incentive compensation (likely including revenue based compensation and incentives without a cap on total payments); (2) payments of personal expenses (e.g., vacation homes, legal fees, automobiles, spousal travel); (3) personal meals and gifts to family and friends; (4) payment to the insider's for-profit corporation in excess of fair market value of services; and (5) loans to insiders or disqualified persons.

***Cell Phones, Laptops and Other Low-hanging Fruit.*** A number of tax-exempt health care organizations continue to provide cell phones, laptops and other property (including in some cases automobiles) to executives and even pay club dues in some cases. The dollar amount of these perquisites, when added to other compensation, still may be well within the range of reasonable compensation based on market comparables; however, failure to properly report those items as compensation results in a per se excess benefit under the regulations (absent other evidence of intent to treat the payments as compensation).[11] Certain nontaxable fringe benefits and expense reimbursements paid pursuant to an ''accountable plan'' are excluded from the substantiation requirement.[12] In many cases, however, such as with the use of automobiles, laptops, cell phones and other ''listed property,'' it is necessary to keep and maintain records of business use to determine the portion of their value that is a nontaxable fringe benefit.[13] It may not be sufficient to simply maintain certifications of ''no personal use'' for laptops, cell phones or automobiles. Failure to do so can result in the entire value being taxable to the employee and poten-

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[10] 26 C.F.R. §§ 53.4958-3(b) & (c).

[11] 26 C.F.R. § 53.4958-4(c).

[12] 26 C.F.R. §§ 53.4958-4(a)(4) & (c)(2).

[13] *See* 26 C.F.R. § 1.62-2(e)(2); *see also* IRS Fringe Benefits Audit Techniques Guide (02-2005), available online at http://www.irs.gov/businesses/corporations/article/0,,id=134943,00.html.

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tially a *per se* excess benefit (if the employee is a disqualified person).

To deal with this potential trap for the unwary, many organizations have reduced their perquisites for executives (in some cases increasing total compensation in a like amount), others have treated all of these items as compensation (in some cases with a ''gross up'' in total compensation to cover the increased tax liability), and others have implemented more detailed recordkeeping requirements. Which approach makes the most business and legal sense will vary by organization and likely will be affected by the organization's culture, existing pay levels, and appetite for increased administrative and recordkeeping burdens (compared to historical practices).

***Loans to Insiders.*** The findings reflected in the report also reflect the basis for the IRS concern with insider loans. Of the loans reviewed in the initial phases of the project, 53% were on terms more favorable than commercially available; and 31% were not paid on time. As a result of these potential abuses, the IRS expanded the Executive Compensation Initiative to include an additional 200 compliance check letters and 50 examinations focused on insider loans.

In light of the potential abuses discovered in this area, many organizations may need to implement a higher level of scrutiny for loans. In addition, legislative changes made in 2006 effectively preclude insider loans for certain exempt organizations such as many health care holding companies. Section 1242(b) of the Pension Protection Act of 2006 (PPA),[14] amended Section 4958 to add a new type of excess benefit transaction for all Section 509(a)(3) supporting organizations (including hospital holding companies). Under Section 4958(c)(3), it is now an excess benefit transaction for a Section 509(a)(3) supporting organization to (1) provide any grant, loan, compensation or other similar payment to a substantial contributor (greater of 2% of donations or $5,000, and the creator of a trust if the trust is the Section 509(a)(3) organization) or his/her family members or an entity in which they have at least 35% control; or (2) provide a loan to any disqualified person, including loans to another Section 509(a)(3) supporting organization but not including loans to any Section 509(a)(1), (a)(2) or (a)(4) organization. In each case, the excess benefit would be the entire amount of the grant, loan, compensation or other similar payment. In addition, with respect to each applicable tax exempt organization, the definition of ''disqualified person'' would be expanded to include anyone who is a disqualified person of a Section 509(a)(3) organization that supports the applicable tax exempt organization (e.g., a director of a hospital holding company that is a Section 509(a)(3) organization would be a disqualified person as to the tax-exempt hospital as well as to the parent).

Although the final version of the PPA includes a typographical error in the effective date provision in Section 1242(c)(2), from the caption and from subsequent IRS guidance it appears that the new excess benefit provisions described above for loans, etc. was intended to apply to all transactions occurring on or after July 25, 2006, even though the PPA did not become law until Aug. 17, 2006. The IRS has provided limited transitional relief for certain arrangements committed to prior to enactment of the PPA which would be excess benefit transactions solely by virtue of the PPA (i.e., if the transaction would have been an excess benefit transaction without enactment of the PPA, such as a below market rate loan to a disqualified person, the transitional relief does not protect the participants). Transitional relief is available for payments made on or before Aug. 17, 2007 on any grant, loan, compensation or similar payment covered by new Section 4958(c)(3) in the following circumstances: (1) the payments are made pursuant to a binding written contract in effect on Aug. 17, 2006 and at all times thereafter until payment is made, with no modification of the contract during the transition period (other than termination of the contract); and (2) payments without a binding written contract if such arrangement involves an employment relationship or other legal obligation in effect on Aug. 17, 2006 and at all times thereafter until payment is made, with no modification of the contract during the transition period (other than termination of the contract), and provided that all required goods and services were delivered and performed as required by the arrangement on or before Dec. 31, 2006.[15]

***Form 990 Revisions.*** One likely result of the Executive Compensation Initiative will be further clarification, and hopefully simplification, of the compensation reporting requirements on Form 990 and in the Instructions. Recent changes to Form 990 have added substantial complexity to the compensation reporting process, which may further exacerbate the high error rate in reporting that the IRS discovered in its review. The report itself suggests that further revisions are necessary to increase the data gathered on compensation arrangements and its utility.

Areas ripe for confusion in the Form 990 include the myriad ways in which fringe benefits and deferred compensation are reported, recordkeeping problems with identifying payments to former insiders and the complex set of relationships that may trigger reporting of relationships with and/or compensation paid by related organizations. To date, changes in the Form 990 illustrate that the IRS is willing to work with the exempt organizations community to clarify reporting requirements. The report on the Executive Compensation Initiative suggests that further simplification is needed, but it also recommends revising Form 990 to ask organizations to identify potential areas of noncompliance such as loans to directors and officers. The IRS has been willing to allow some lead time in practice for organizations to become familiar with new reporting requirements. There is, of course, no guaranty of such a cooperative approach in any particular case, and the more significant the reporting failures the more likely the IRS would be to take an aggressive enforcement approach. In that regard, the report suggests reconsidering when penalties should be assessed for filing an incomplete Form 990.

More than ever, the Form 990 is not merely a reporting tool but a potential liability document. It is likely to be the source of more data mining by the IRS, and a more serious response to failures to report properly. In addition to clarifying confusing aspects of Form 990, it is likely that the IRS will begin soliciting additional information regarding compensation decisions, potentially including one or more of the following disclosures: whether the organization follows the rebuttable

[14] Pub. L. No. 109-280.

[15] Notice 2006-109, 2006-51 I.R.B. 1121, § 4.

presumption review process; whether compensation of disqualified persons, the five top paid employees and the five top paid independent contractors for professional and other services is supported by written documentation of reasonableness including comparables; and whether the organization provides disqualified persons with cell phones, laptops, automobiles or other property that may have mixed business and personal uses. Although Form 990 already asks if the organization has adopted a written conflict of interest policy, it seems inevitable that the IRS eventually will ask organizations to include copies of those policies once with Form 990, and to attach any amendments in future years. Public disclosure of those policies also may heighten scrutiny of the compensation process and other transactions with insiders in the media and by other stakeholders.

## Preview of Coming Attractions

***Effectiveness of Soft Contact Letters.*** The IRS continues to face a dilemma common in many organizations, public and private—the need to do more with less. Soft contact letters are one way that the IRS can effectively reach a higher volume of taxpayers and potentially have a greater industry-wide effect on compliance than with traditional full-scale audits. By directly focusing on particular organizations and their specific return positions, the IRS is also able to have a more personalized educational impact on exempt organizations. In that regard, it would seem that most organizations would pay more attention to a letter from the IRS to one of their executives asking, why was the compensation report on your Form 990 incomplete than they would a general instruction in Form 990 about the need for complete disclosure of compensation arrangements.

In fact, only last year we saw another example of this new approach in the community benefit questionnaire sent to approximately 600 hospitals. Although that questionnaire focused on a wide array of community benefit activities (in 72 questions), it also included a streamlined set of nine questions on executive compensation topics. Clearly the IRS is serious not only about using soft contact letters more frequently, but also about building a database that can inform future audits of the community benefit standard and executive compensation practices.

***Whistleblowers and the IRS.*** Another recent development of note is the increased incentives for whistleblowers in the federal tax area created by Congress in the Tax Relief and Health Care Act of 2006 (''TRHCA''). Section 406 of TRHCA added a new subsection (b) to Section 7623 of the Code to provide for a maximum bounty for whistleblowers of up to 30% of the taxes recovered, including penalties and interest, with a floor of at least 15% (prior IRS practice provided for a maximum 15% reward). To qualify for the floor and maximum, a whistleblower must provide information that substantially contributed to the recovery. In other cases, the IRS has discretion to award up to a 10% bounty; however, to be eligible for any reward, the information must be submitted under penalties of perjury. TRHCA also provides for an appeal process for whistleblowers to contest their entitlement to and amount of reward, with jurisdiction of such disputes residing in the Tax Court and all appeals required to be filed within 30 days of the determination of the amount of the reward. The legislation also did not lift the tax bar under the False Claims Act (i.e., tax whistleblowers may not institute litigation themselves to enforce the tax laws but rather must rely on the IRS to take action).[16]

These new provisions only apply to disputes involving more than $2 million in taxes, penalties and additions to tax. By way of example, an alleged excess benefit of approximately $890,000 would result in excise taxes under Section 4958 of more than $2 million at the 225% tax rate if not timely corrected. If the transaction were a willful excess benefit, the triggering amount would be half ($445,000) due to the 100% penalty that would apply. Senate amendments to the minimum wage bill (H.R. 2), however, would, if enacted, lower the threshold for the new whistleblower provisions to $20,000 in potential tax liability (instead of $2 million). That lower threshold, if adopted, could result in a significant number of claims affecting not only tax-exempt hospitals but also physician practices.

TRHCA also mandated the establishment of a Whistleblower Office within the IRS, and the first Director of that new Office was appointed on February 2, 2007. The Whistleblower Office is responsible for analyzing information received under Section 7623(b) and either investigating it directly or assigning it to the appropriate IRS office for investigation. Finally, Section 406 of TRHCA requires an annual report to Congress on the use of Section 7623 by whistleblowers and a recommendation for any needed changes in the law or administrative practice.

***Traditional Case Referrals***. In addition to the likely increase in whistleblower activity, traditional sources of examination referrals are likely to continue to feed into future IRS executive compensation reviews. For example, potentially excessive or poorly reported compensation may be identified as a potential issue in the course of an audit on seemingly unrelated issues such as worker classification. IRS agents themselves also may note developments and allegations in the local or national press focusing on an organization's compensation practices or perceived lack of transparency in operations. State agencies too may seek the IRS' assistance in investigating nonprofits when the states lack the resources or expertise to do a thorough job.

## State Considerations

***Effect on State Law Enforcement Activities.*** Federal initiatives in the fraud and abuse area have often been followed by similar, coordinated state enforcement activities. It now appears that tax law enforcement initiatives may be about to exhibit a similar degree of coordination. Under Section 1224 of the PPA, the IRS is now allowed to disclose to the appropriate state officer (e.g., Attorney General or state tax officer) upon written request any notice of a proposed refusal to recognize an organization as exempt under Section 501(c)(3) or a proposed revocation of exemption under Section 501(c)(3), together with their tax returns and return information (which would include Form 990-T). Similar disclosures may be made with respect to organizations described in Sections 501(c)(2), 501(c)(4), 501(c)(6) and certain other exempt organizations. The range of what can be disclosed would include closing agreements with the IRS, which until now had been confidential except in rare cases by agreement (e.g., Hermann Hospital). As

[16] 31 U.S.C. § 3729(e).

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a result, increased enforcement at the federal level is likely to fuel increased enforcement at the state level. That enforcement may take the form of charitable trust reviews, breach of fiduciary duty challenges, consumer protection act investigations, property tax exemption challenges or proposed legislation or administrative rules aimed at perceived abuses.

***Ceiling on Executive Compensation.*** To date, the IRS and Congress have not imposed any specific dollar amount ceiling on executive compensation from tax-exempt entities. There have been, however, some efforts in that direction in recent years at the state level. One noteworthy example was Michigan House Bill 6365 (introduced 12/02/04), which sought to cap the compensation of all hospital executives and other administrative employees. If passed as introduced, that legislation would have limited those employees' compensation to no more than 1200% of the federal poverty level for a household of the same size as the employee's household. Using the federal poverty level tables for the first year that would have been affected (2005), the cap would have amounted to pay of no more than $114,840 for a single executive, and $232,200 for an executive with a family of four.[17]

Less than two years later, in June 2006, the Ohio Attorney General proposed (and later withdrew) sweeping new rules governing the operation of charitable organizations (including many hospitals and HMOs). One part of the proposal was a Model Compensation and Expense Reimbursement Policy which would have established a presumption that payment of compensation to any employee of a charitable organization in excess of 30 times the minimum wage (or $321,600 at the time) generally would not be in furtherance of charitable purposes.[18] The proposed Model Policy also provided that, if the dollar limit is exceeded in any compensation package, there must be certain procedural safeguards in place, including at least ''approval by a supermajority of the full [board], . . . with the full knowledge of the total Covered Compensation paid to the covered person by the charitable organization and such other Related Third Parties as may be compensating the covered person.''[19]

There are, of course, no comparable limits on compensation in the for-profit sector. At most, absent violation of securities laws, payment of higher amounts of compensation may have negative tax consequences but it is not illegal. Many nonprofit organizations, particularly in the health care sector, compete with for-profit employers for executive talent as well as for other employees. Capping compensation below market levels for top talent thus might be expected to contribute to a ''brain drain'' from the nonprofit sector to the for-profit sector.

## Conclusion

Given the continued and growing interest of the IRS in executive compensation, it may be prudent for exempt organizations to review their compensation policies and, in particular, focus on maintaining an appropriate degree of board oversight of the executive compensation process, updating policies on use and payment for cell phones, and verifying the accurate tracking of other perquisites (e.g., computers for home use, auto allowance). Where sheer volume, limited volunteer time or expertise, or strong market support for modest compensation levels make a board or committee review of all compensation arrangements with potential disqualified persons impractical, the board or committee may be able to delegate approval to one or more officers (other than for their own compensation).[20] Such delegated approvals still can be used to establish the rebuttable presumption if the approving individuals are conflict- free for the particular transaction (including no quid pro quo to approve each other's compensation), base their decisions on adequate market data of comparable compensation for comparable positions and organizations, and document their decisions in the file in writing on a timely basis.[21]

Documentation is a key portion of establishing a rebuttable presumption of reasonableness. Accordingly, it can be useful to develop a template for minutes of compensation decisions, at the committee and board levels, that closely mirrors the requirements spelled out in IRS regulations for establishing a rebuttable presumption of reasonableness.[22] Such renewed attention to the compensation process and proper documentation is also prudent in light of other corporate responsibility developments, such as the recurring Congressional proposals to require senior executives to certify the accuracy of Form 990 filings (including the disclosure of whether or not the organization participated in an excess benefit transaction), the GAO survey of compensation practices at several large health care systems nationally and recent pronouncements of best practices in nonprofit governance from the IRS and the Independent Sector's Nonprofit Panel. Although no specific reforms are mandated by law, at least on the federal level (aside from certain loans by supporting organizations), the pressure for voluntary reforms in the sector continues to mount, particularly in the areas of executive compensation and insider transactions.

[17] 70 Fed. Reg. 8373.
[18] Prop. Ohio Admin. Code § 109:1-1-11(A)(6)(a).
[19] *Id.*
[20] 26 C.F.R. §§ 53.4958-6(c)(1)(i)(B) & (C).
[21] 26 C.F.R. § 53.4958-6(a).
[22] 26 C.F.R. § 53.4958-6(c)(3)(i).