



THE IRS FOCUS ON EXECUTIVE COMPENSATION: *Will You Be Targeted?*

It's no surprise that executive pay at for profit companies is under the microscope, but senior executives at tax-exempt hospitals often wonder why they are also in the spotlight. The scrutiny of executive compensation at tax-exempt hospitals that has intensified over the past decade doesn't show signs of letting up. In fact, in October, the IRS indicated that it may send compliance check letters to some 600 nonprofit hospitals seeking information about their executive compensation practices.

You can ensure your organization's compliance and prepare for new changes by understanding why and how the IRS and lawmakers are looking at executive compensation practices at tax-exempt hospitals.

COMPENSATION SCRUTINIZED

Just as the corporate world has been rocked by compensation abuse, tax-exempt organizations have dealt with compensation ethics. Consider the problems at United Way headquarters several years ago and the controversial retirement/severance package granted to the retiring CEO of the NYSE (a nonprofit corporation). Remember the head of the private foundation who tried to justify an extra \$1 million in compensation for his daughter's wedding? The news of "sweetheart" deals between a major conservation organization and individuals with positions of substantial influence? Lawmakers and the IRS are now focusing on hospitals, the largest segment of the exempt organizations "market."

WHEN DID EXECUTIVE PAY AT HOSPITALS BECOME A PUBLIC ISSUE?

Little attention was paid to executive compensation at hospitals until the enactment of the intermediate sanctions excise taxes on July 30, 1996, which enabled the IRS to directly penalize individuals who took advantage of exempt organizations. (Until then, the only remedy was to revoke the tax-exempt status of the organization for the misdeeds of one or a few bad actors.)

Last year, both the IRS and Congress rallied to intensify exempt organization enforcement. IRS Commissioner Mark Everson pledged to strengthen enforcement capacity, including exempt organization enforcement, and Ways & Means Committee Chair Bill Thomas announced plans to conduct reviews of exempt organizations to see if their tax-exemption is justified.

In June 2004, the staff of the Senate Finance Committee proposed applying the private foundation self-dealing rules to public charities and reducing permitted reliance on the "rebuttable presumption of reasonableness" for compensation arrangements. In August, the IRS rolled out an enforcement effort aimed specifically at excessive compensation

provided by exempt organizations to officers, directors and others. The IRS also revised the Form 1023 (the Exemption Application), asking for more detailed information concerning compensation determinations.

THE CURRENT COMPLIANCE PICTURE

This year, the IRS and Congress have continued to focus on the issue. In January, the Joint Committee on Taxation identified legislative options for improving tax compliance, including reforming the intermediate sanctions provisions by converting the "rebuttable presumption of reasonableness" into a minimum standard of performance for compensation arrangements and transactions with disqualified persons. In June, the Panel on the Nonprofit Sector proposed cracking down on those who approve excessive compensation at charitable organizations. Finally, in October, the IRS released a revised draft of Form 990 for the 2005 tax year, significantly increasing the amount of information requested concerning compensation of officers and directors and requesting information relating to any loans, advances, or deferred compensation for former officers and directors. Also in October, as mentioned above, the IRS released guidelines which suggested that it would be sending compliance check letters to hundreds of hospitals.

WHAT'S NEXT?

Although legislative changes are difficult to predict, the Congressional mood seems increasingly hostile. Prepare now for legislation impacting compensation methodology and requiring full disclosure of compensation determinations and amounts, including deferred compensation, or for an IRS compliance check. Be sure to:

- Become thoroughly familiar with the intermediate sanctions rules;
- Ensure that boards and board committees take timely and appropriate action in reviewing and approving compensation determinations, including use of appropriate comparability data, and contemporaneously documenting all actions taken by "disinterested" board members;
- Review conflicts of interest policies to ensure (1) comprehensiveness; (2) application to all board members, senior officers, and independent contractors with substantial financial commitments, (3) consistent application in practice (and documentation of all actions taken in meeting minutes); and (4) collection of annual written certifications regarding compliance with the conflicts policy from all covered persons;
- Review 990s prior to filing to assure full and accurate disclosure of compensation information.

If you have a question on this material, or would like to discuss legal services, please contact us at healthcare@duanemorris.com.

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