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Executive Compensation in the Headlights: Challenges Ahead For Nonprofit Hospitals in Compensating Executives

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With increased transparency mandated by the revisions to the Internal Revenue Service Form 990 and the business of not-for-profit hospitals brought to the forefront by the Obama administration's focus on the dramatic rise of health care costs, executive compensation practices of hospitals have become subject to intense public scrutiny and increasing government regulation. Because of their status and the rules applicable to them, not-for-profit hospitals cannot take advantage of the compensation programs that are available to for-profit corporations. To be competitive in recruiting and retaining the ''best and brightest'' executives to run tax-exempt entities, boards have developed specialized compensation plans and programs for highly regarded executives. The government, initially focusing on the plans of for-profit corporations, has more recently begun to take a hard look at the plans and programs of tax-exempt entities by using the rules, regulations, and penalties of the Internal Revenue Code of 1986, as amended (the code) to pressure tax-exempt entities into rewarding executives with compensation limited to that which the government believes is reasonable under the law.[1]

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Executive compensation practices now are being examined under the basic tenets of the income tax law with a particular eye toward challenging both the *time* of payment, so that the income taxation is not impermissibly deferred into the future, as well as the *amount*

[1] A discussion of any state or local tax law implications is beyond the scope of this article.

of payment, so that only "reasonable compensation" (as defined by the government) is paid to the chief executive officers of the largest tax-exempt entities.

This article examines the rules, applications, and penalties associated with any failure to comply with IRS requirements. After a review of the rules applicable to the taxation of deferred executive compensation, we discuss the requirements for reasonable compensation and the ''intermediate sanctions'' that may be imposed both upon the executive *and*the tax-exempt health care entity's officers, directors, or trustees if the IRS establishes that payments are unreasonable or excessive compensation. Finally, we look at the recent focus by the IRS and other governmental agencies on audits of tax-exempt health care entities. Knowing the rules and establishing practices that comply with them are key to withstanding the scrutiny by the government and the adverse publicity that can accompany these audits.

I. Tax Rules for Deferred Compensation of Tax-Exempt Health Care Entities and the Impact of Sections 409A and 457(f) of the Code

For-profit corporations are not subject to the same tax rules for deferred compensation and retirement plans as not-for-profit hospitals and other tax-exempt health care entities. Accordingly, for-profit corporations can offer stock options and more attractive deferral and retirement packages, making it more difficult for not-for-profit hospitals to compete for executive talent.[2] Although tax-exempt health care entities are permitted to provide deferred compensation and retirement income through tax-qualified retirement plans, such as 401(k) savings plans or 403(b) annuity plans, these plans are subject to annual dollar limitations on deferrals and contributions. All other types of deferral or retirement plans offered to employees of tax-exempt health care entities are governed by Section 457 of the code. This means that *all* deferred compensation or retirement income provided to executives of not-for-profit hospitals in excess of the annual dollar limitations on deferrals and contributions under a tax-qualified retirement plan must comply with Section 457 of the code.

Any deferred compensation arrangements that do not fall within the definition of Section 457(b) of the code (the 457-(b) plans), or that do not meet the bona fide severance pay plan exception under Section 457(e)(11)(A)(i) of the code, are ''ineligible'' arrangements governed by Section 457(f) of the code (the 457-(f) plans).[3] 457-(f) plans are not subject to the annual contribution limitation that applies to 457-(b) plans, however, any benefits provided will be subject to immediate taxation upon vesting, which is deemed to occur upon the lapse of a ''*substantial risk of forfeiture.*'' ''Substantial risk of forfeiture'' is defined under Section 457(f)(3)(B) of the code to mean that a person's rights to compensation are ''conditioned on the future performance of substantial services.''[4]

In October 2004, Congress enacted Section 409A of the code, a new statute that imposed additional tax requirements on deferred compensation arrangements. Prior to the enactment and the issuance of final guidance under Section 409A of the code, many different design alternatives were utilized to allow 457-(f) plans to provide for retention incentives and retirement income without earlier taxation as a result of a lapse of a substantial risk of forfeiture. As a result of the passage of Section 409A of the code, many of the design alternatives that were utilized in the past no longer may be valid.

One design alternative has been the so-called ''*rolling risk of forfeiture,*'' whereby a participant would elect some time prior to vesting to defer the scheduled payment under the 457-(f) plan for an additional number of years on the basis that the ''substantial risk of forfeiture'' continues to apply. Prior to the enactment of Section 409A of the code, the existence of a ''substantial risk of forfeiture'' was determined by applying principles set forth under Section 83 of the code and the

[2] In the for-profit sector, an employer may offer a nonqualified deferred compensation plan to a select group of management or highly compensated employees. These plans are not subject to dollar based limitations and may be structured to allow deferral through retirement and beyond. It is important to note that these plans are not available to tax-exempt health care entities because of the application of Section 457(f) of the code as discussed below.

Another limitation on compensating executives is that tax-exempt health care entities generally are *not* permitted to issue any form of equity interests to employees.

[3] There are two types of deferred compensation arrangements under Section 457 of the code: (1) ''*eligible*'' arrangements governed by Section 457(b) of the code; and (2) ''*ineligible*'' arrangements governed by Section 457(f) of the code. 457-(b) plans allow for the deferral of compensation and the benefits are not taxed to the participant until the benefits are distributed. 457-(b) plans are subject to the same IRS annual deferral limitations under tax-qualified 401(k) plans. The IRS annual deferral limitations for 457-(b) plans are subject to the same limitation as salary deferrals under tax-qualified 401(k) plans—$16,500 in 2010. The limit that applies to 401(k) plan deferrals does not reduce this limitation, so that an employee may double their available deferrals by deferring $16,500 to the 457-(b) plan and $16,500 to the 401(k) plan (plus a $5,500 catch-up contribution allowable if the employee is age 50 or more). Further, under Section 457(e)(11)(A)(i) of the code, *both* 457-(b) plans and 457-(f) plans exclude any ''bona fide vacation leave, compensatory time, severance pay, disability pay, or death benefit plan.''

[4] Section 83(c)(1) of the code also provides that a person's rights are subject to a substantial risk of forfeiture if the rights are ''conditioned on the future performance of substantial services.'' Under Treas. Reg. § 1.457-11(d), when there is any transfer of property, Section 83 of the code applies. The application of the term under Section 83 of the code frequently has been relied upon in understanding the definition of ''substantial risk of forfeiture'' under 457-(f) plans. Under Section 83 of the code, a substantial risk of forfeiture exists where the rights in the property are conditioned ''upon the future performance (or refraining from performance) of substantial services by any person'' or ''the occurrence of a condition relating to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.'' Treas. Reg. § 1.83-3(c)(1). Many deferred compensation arrangements offered to executives of a tax-exempt health care entity are designed to retain the services of a participant through a participant's retirement. The deferred compensation under the arrangement must be subject to a ''substantial risk of forfeiture,'' which means that a participant who leaves employment prior to retirement would be required to forfeit the deferred compensation.

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doctrine of constructive receipt.[5] However, applying those principles to a ''rolling risk of forfeiture'' is now in question.

Another design alternative has been to subject the deferred compensation to a binding noncompetition covenant. This technique also no longer may be effective. Under the regulations promulgated pursuant to Section 83 of the code, there are illustrations of ''substantial risk of forfeiture'' that allow for the possibility that a noncompetition covenant could constitute the ''refraining from performance'' of substantial services depending on the facts and circumstances,[6] *e.g.*, the age of the employee, the availability of other alternative employment opportunities and the likelihood of obtaining other employment. Imposing a noncompetition covenant on a retiring employee, however, is not likely to constitute a ''substantial risk of forfeiture'' unless the employee is expected to perform substantial services. A position that the covenant to refrain from performing services at a competing organization could be justified as a substantial risk of forfeiture will depend on the facts and circumstances, especially in certain tax-exempt organizations where talent and expertise are particularly prized.

Another approach, the applicability of which also is under attack, has been to characterize the compensation as severance. As discussed above, Section 457(e)(11)(A)(i) of the code specifically exempts bona fide severance pay plans from the requirements under Section 457 of the code. The determination of whether a severance arrangement constitutes a bona fide severance pay plan for this purpose has not been clear. Restricting the payment of severance to the occurrence of an involuntary termination (other than for cause) should make the payment subject to a ''substantial risk of forfeiture'' because the requirement to continue to perform substantial services applies through the termination date and the possibility of forfeiture is substantial.

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The landscape for executive compensation for not-for-profit hospitals changed in October 2004 when Congress enacted Section 409A of the code. Section 409A of the code revised the taxation principles applicable to *all* deferred compensation arrangements, whether or not in the for-profit or tax-exempt sector.[7] All deferred compensation arrangements now are subject to the requirements under Section 409A of the code, including deferral and re-deferral rules and limitations on events that allow for distributions. Significant income tax penalties apply if the rules are not complied with, which include immediate inclusion of income, a 20 percent penalty tax and assessment of significant interest tax penalties, *all of which are payable by the executive.*[8]

In April 2007, the Treasury issued final regulations under Section 409A of the code that specifically state a right to a payment is subject to a ''*substantial risk of forfeiture*'' only if entitlement to the amount is conditioned upon the performance of ''*substantial future services*.'' These regulations make clear that the addition of any risk of forfeiture *after* the right to the compensation arises, or any extension of a period during which compensation is subject to a substantial risk of forfeiture (*i.e.*, a ''rolling risk of forfeiture''), will be disregarded for purposes of determining whether such compensation is subject to a ''substantial risk of forfeiture.''[9] In other words, the deferral of a ''substantial risk of forfeiture'' will not be recognized and the amount deferred will be subject to immediate income taxation and penalties.[10] These regulations also provide that an agreement to refrain from performing services (*i.e.*, a noncompetition covenant) does not constitute a ''substantial risk of forfeiture.''[11]

Thus, the previously existing rules for 457-(f) plans and the new final rules under Section 409A of the code do not provide the same definition of ''substantial risk of forfeiture.'' Further, the definition of ''substantial risk of forfeiture'' under Section 409A of the code appears to be significantly more restrictive than the definition as previously applied to 457-(f) plans under Section 457(f) of the code. Recognizing this conflict, in August 2007, the IRS issued IRS Notice 2007-62, which states that the IRS intends to publish future guidance applying the definition of ''substantial risk of forfeiture'' under Section 409A of the code.[12] This would appear to erode the designs discussed above based on the ''rolling risk of forfeiture'' and noncompetition covenants.[13] According to IRS and Treasury officials, future guidance will be issued in the form of proposed

[5] The doctrine of constructive receipt generally applies whenever a cash-basis taxpayer is entitled to compensation, the compensation is immediately available to the taxpayer, and the failure to receive it is due entirely to the taxpayer's own volition. Treas. Reg. § 1.451-2(a).

[6] Treas. Reg. § 1.83-3(c)(2).

[7] Certain deferred compensation arrangements, such as tax-qualified retirement plans and 457(b) plans, are specifically exempt from Section 409A of the code.

[8] Although the executive has the ultimate responsibility for paying excise taxes under Section 409A of the code, tax-exempt health care entities also are obligated to properly report and withhold compensation paid to the executive on IRS Forms W-2, 1099 and 941, as applicable. Further, if an entity fails to report an operational or documentary failure under Section 409A of the code, the entity may be subject to penalties for failure to properly report and withhold on IRS Forms W-2 and 941 pursuant to the penalty provisions of the code, generally found under Subtitle F of the code.

[9] Treas. Reg. § 1.409A-1(d)(1).

[10] The only ability to re-defer deferred compensation under Section 409A of the code is under the re-deferral rules. Treas. Reg. § 1.409A-2(b)(1) provides that: (i) the election may not be effective until at least 12 months after the date the election is made; (ii) the plan requires that the payment be deferred for a period of not less than five years; and (iii) the election must be made at least 12 months prior to the date the payment is scheduled to be paid. The re-deferral rules do not impact whether an amount is subject to a ''substantial risk of forfeiture,'' but rather only address the timing of the distribution.

[11] Treas. Reg. § 1.409A-1(d)(1).

[12] See IRS Notice 2007-62, 2007-32 IRB which may be relied upon immediately. IRS Notice 2007-62 further states that future guidance likely would be applied prospectively and, with respect to periods before such guidance is issued, no inference should be made from the guidance in IRS Notice 2007-62.

[13] Although it is not certain when the future guidance will be issued, there may be some transition period, during which existing deferred compensation arrangement may be permitted to amend their plans. IRS Notice 2007-62 states that, with respect to periods before such future guidance is used, ''no inference'' should be made from the anticipated guidance as described in the Notice. IRS and Treasury officials have stated that although taxpayers should not expect grandfather relief in the future guidance, the Treasury and IRS intend to look forward.

regulations under Section 457 of the code. These proposed regulations previously were anticipated to have been published near the end of 2009, but to date have not been published.[14]

IRS and Treasury officials also have stated that, in the same proposed regulations, the exception for bona fide severance pay plans under Section 457(e)(11)(A)(i) of the code will be further restricted as severance plans are viewed as providing deferred compensation.[15] Officials have said the proposed regulations will define bona fide severance pay plans as a severance arrangement payable only if: (i) the termination of employment is involuntary; (ii) the severance does not exceed two times the employee's salary; and (iii) the severance is capped at the limit under Section 401(a)(17) of the code (*i.e.*, $245,000 for 2010).[16] Any severance arrangement in excess of those limits arguably would be a 457-(f) plan and would not meet the requirements for a ''substantial risk of forfeiture.'' In that case, there would be immediate taxation and the 457-(f) plan would not meet the purpose of deferring compensation, further narrowing the design alternatives with respect to severance.

Although the tax rules applicable to 457-(f) plans are in flux, it seems clear that any proposed or final guidance under Section 457(f) of the code will subject 457-(f) plans to many of the same restrictions currently under Section 409A of the code. These rules are less flexible and appear to further limit the ability of not-for-profit hospitals to design 457-(f) plans that meet the goals of providing deferral incentives and retirement income to executives.

Today, many different design alternatives are being explored to comply with the new and anticipated guidance under Sections 409A and 457 of the code. For example, Section 409A of the code expressly allows for distributions upon certain permitted distribution events, i.e., death, disability, unforeseeable emergency, change in control event, separation from service, or fixed time or schedule. Many of these distribution events could be included in a 457-(f) plan, including distribution upon attainment of a certain age, age and years of service, involuntary separation from service, death or disability.

Other design alternatives are being explored to comply with the new definitions of ''substantial risk of forfeiture'' and the vesting requirements under Sections 409A and 457(f) of the code. Vesting for this purpose means that the executive must be required to perform substantial services through the vesting date. These possibilities include:

- Cliff vesting of deferrals, for example, a fixed amount is deferred and becomes fully vested and payable on the third anniversary of the award provided the executive performs services through that date.
- Vesting at attainment of certain age requirements, such as requiring the executive to be employed through normal retirement age.
- Annual vesting of deferrals, such as providing for the deferral of a fixed amount, that vests pro-rata in equal parts on the first, second, and third anniversary of the award provided the executive is employed on each vesting date.
- Overlapping deferral periods, such as each year providing for an award in year 1 of deferred compensation that vests and is paid on the third anniversary, an award in year 2 that vests and is paid in three years, and an award in year 3 that vests and is paid in three years. Year 1 award would vest in year 4, year 2 award would vest in year 5 and year 3 award would vest in year 6, and so on.

The vesting alternatives described above could be included in a deferred compensation program alone or in any combination of alternatives.

Upon the lapse of a ''substantial risk of forfeiture'' under a Section 457(f) of the code, the deferred amounts are included in income as wages in the year in which the risk of forfeiture lapses. Given this requirement, another design approach would be to provide that the amount that lapses be included in income, but not necessarily paid to the executive until the distribution event.

All of the design approaches discussed above likely will be utilized to a greater extent to assure compliance with the new standards for deferred compensation. Although these approaches may result in a shorter time period for deferral, creative plan design alternatives are worth exploring in the design of deferred compensation programs of tax-exempt health care entities.

This could mean that once the guidance is issued, deferred compensation that does not comply with the new rules will be subject to income inclusion in the year guidance is issued, or a transition period may be provided that would allow for documentary correction. However, given the statements made in IRS Notice 2007-62, a transition period might not be granted, which would suggest that all existing agreements that provide for a ''rolling risk of forfeiture'' will be required to ignore any extension of the vesting period. If the initial vesting period (*i.e.*, the first vesting period) has expired, the deferred compensation then likely would be subject to immediate income taxation in the year guidance is issued or made effective.

[14] 33 *Daily Tax Report*, G-2, Feb. 22, 2010, IRS Counsel Highlights Severance Rules in Guidance Under Tax Code Section 457(f) (summarizing statements made by Cheryl Press, senior attorney in the IRS Office of Chief Counsel for Tax Exempt and Government Entities, at the Feb. 18 annual Washington Not For Profit Legal and Tax Conference).

IRS and Treasury officials also indicated that the rules for income taxation inclusion for 457-(f) plans would differ from rules under Section 409A of the code on income tax reporting rules. Upon the lapse of a ''substantial risk of forfeiture'' under 457-(f) plans, the deferred amounts subject to the risk of forfeiture will be included in income as wages in the year in which the risk of forfeiture lapses. Under the proposed regulations promulgated under Section 409A of the code, amounts are included in income in the year in which they are vested and calculated by the ''amount deferred'' over any amount that is subject to a ''substantial risk of forfeiture.'' Prop. Treas. Reg. § 1.409A-4(a)(1)(i). As indicated, the proposed regulations under Section 457(f) of the code will contain rules requiring that the present value of the deferred compensation be determined each year. It is unclear how that amount will be determined and whether the reduction of the amount deferred for amounts subject to a ''substantial risk of forfeiture'' under Section 409A of the code will be available to 457-(f) plans.

[15] Id.

[16] Id. IRS Notice 2007-62 includes substantially similar language.

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II. Reasonable Compensation & Tax Penalty Avoidance

Another challenge for tax-exempt health care entities[17] (and their managers) is establishing ''reasonable compensation'' for their officers, directors, trustees, and other ''disqualified persons''[18] as defined under Section 4958 of the code. If a tax-exempt health care entity provides unreasonable or excessive executive compensation, an ''excess benefit transaction'' is considered to have occurred.[19] An excess benefit is conveyed when the entity is not receiving consideration from the individual providing services that is commensurate with its payment of compensation. Thus, a failure to pay reasonable compensation can trigger significant income tax penalties under Section 4958 of the code to the executive who received the overpayment and to certain managers within the organization who approved the excessive compensation (so-called ''intermediate sanctions''). It also can jeopardize the entity's tax-exempt status.

Under Section 4958 of the code, the IRS can impose ''intermediate sanctions'' on excess benefit transactions either in lieu of or in addition to revocation of the organization's tax-exempt status.[20] The ''intermediate sanctions'' are composed of three tiers:

- a 25 percent excise tax imposed on the disqualified person who engaged in an excess benefit transaction with the tax-exempt health care entity (which is equal to 25 percent of the excess benefit for each excess benefit transaction);
- an additional tax equal to 200 percent of the excess benefit imposed on the disqualified person if the excess benefit transaction is not timely corrected by repayment of the value of the excess benefit *plus* any additional amount necessary to compensate the entity for lost use of the funds [21] and
- a 10 percent tax penalty[22] on the tax-exempt health care entity's managers (such as its officers, directors or trustees) who willfully and knowingly participate in a transaction that is an excess benefit transaction.

Thus, not only will the executive be subject to tax penalties but, also members of the entity's governing board who established such compensation will be subject to tax penalties.

In order to avoid these penalties, the Treasury regulations under Section 4958 of the code provide a ''rebuttable presumption'' that most organizations follow to establish that their determination of executive compensation is reasonable and at fair market value. The procedure requires that the tax-exempt health care entity have:

- the organization's governing body, or a committee of such body, composed of individuals who do not have a conflict of interest[23] with respect to such transaction, approve executive compensation in advance;
- a committee that obtained and based its determinations of compensation on comparability data;[24] and
- a committee that sufficiently and contemporaneously documented the basis for its decisions with regard to executive compensation.

The only way the IRS could successfully rebut the presumption that payments are reasonable would be for it to develop sufficient contrary evidence to challenge the probative value of the comparability data relied upon by the authorized body.

In determining the value and reasonableness of compensation, all compensation (with certain exceptions[25])

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[17] Tax-exempt entities subject to the rules discussed herein are those described in Section 501(c)(3) or 501(c)(4) of the code (and does not include a private foundation as defined in Section 509(a) of the code, a governmental entity that is not subject to taxation, a foreign organization tax-exempt under Section 501(c)(3) or 501(c)(4) of the code that receives substantially all of its support from sources outside of the United States, or, an entity whose exemption was never recognized under Section 501(c)(3) or 501(c)(4) of the code or was revoked). IRS long has recognized that not-for-profit hospitals may qualify for exemption as organizations described in Section 501(c)(3) if they further a charitable purpose and are not operating on a proprietary basis.

[18] Disqualified persons are defined under Section 4958 of the code for this purpose as any person in a position to exercise substantial influence over the affairs of the organization at any time during a five-year lookback period. Disqualified persons include family members of the disqualified person and corporations, partnerships or trusts at least 35 percent owned by the disqualified person. See Treas. Reg. § 53.4958-3.

[19] Excess benefit transactions include transactions in which an applicable tax-exempt entity excessively compensates an executive because, in such instances, the entity is viewed as violating a basic tenet of its tax-exempt status–that net earnings of the organization cannot inure to the benefit of private individuals or shareholders. See Treas. Reg. § 53.4958-4.

[20] In determining whether to revoke the tax-exempt status of an organization, the IRS generally will consider all facts and circumstances, including whether the organization has been involved in repeated excess benefit transactions, the size and scope of the excess benefit transactions, whether the organization has implemented safeguards to prevent future recurrences of excess benefit transactions, and whether there was compliance with other applicable laws.

[21] The excess benefit transaction is timely corrected if it is corrected before the earliest of: (i) the date of mailing a notice of deficiency with respect to the 25 percent initial tax; or (ii) the date on which the IRS assesses the 25 percent initial tax. See Treas. Reg. § 53.4958-1(c)(2)(ii).

[22] This penalty with respect to each excess benefit transaction is 10 percent of the excess benefit. See Treas. Reg. § 53.4958-1(a).

[23] A committee member is considered to have a conflict of interest if he or she: (i) is a disqualified person or is related to one; (ii) is in an employment relationship subject to the direction of the disqualified person; (iii) receives compensation subject to approval by a disqualified person; (iv) has a material financial interest affected by the transaction; or (v) approves of a transaction with regard to a disqualified person who has approved or will provide reciprocal approval of a transaction providing economic benefits to the committee member. See Treas. Reg. § 53.4958-6(c)(1)(iii).

[24] Appropriate comparability data includes data concerning compensation levels paid by similarly situated organizations for similar positions, the availability of similar services in the geographic area of the exempt organization, independent compensation surveys compiled by independent firms, and actual written offers from similar institutions competing for the services of the disqualified person. See Treas. Reg. § 53.4958-6(c)(2)(i).

[25] Exceptions include nontaxable fringe benefits under Section 132 of the code. Also, a fair market value analysis of compensation under Section 4958 of the code does not apply to any fixed payment that is specified to be made to a person pursuant to an initial contract. See Treas. Reg. § 53.4958-4(a)(4). An initial contract means a binding written contract between an applicable tax-exempt organization and a person who was not a disqualified person immediately prior to entering into the contract. However, the contract can be disqualified from the

provided by the tax-exempt health care entity in exchange for the performance of services is considered.[26] The tax-exempt health care entity must provide written substantiation of its intent to treat the economic benefits as compensation when it is paid.[27] It can do so by reporting the economic benefit as compensation on original IRS Forms W-2, 1099, or 990. This further increases the transparency of the compensation to be provided.

As discussed further in the next section, recent studies conducted by the IRS have recognized that executive compensation levels at tax-exempt health care entities still appear to remain high. Therefore, the rebuttable presumption procedure has come under attack, especially with regard to perceived abuses in connection with use of comparability data, as well as with regard to how tax-exempt hospitals account for and report their community benefits activities and liabilities.

Thus, under the current landscape, compensation committees should consider engaging independent consultants who can benchmark and compare compensation data specifically within the not-for-profit health care arena. Further, to the extent possible, the compensation analysis should take into consideration the compensation philosophies of the entities that are benchmarked in order to assess appropriate levels of compensation in sync with short or long-term needs, and/or ways to deliver compensation through a combination of cash and deferred arrangements. In addition, compensation committees should prepare and maintain adequate records that supporttheir compensation decisions and undertake compensation reviews on a regular basis that take into account the most current comparability data.

III. Increased Government Regulation Makes Compliance Key

As you can see from the above, there have been significant developments in the law applicable to executive compensation for tax-exempt health care entities. The increased regulation requires not-for-profit hospitals and other tax-exempt health care entities to examine their plans and procedures in order to assure compliance. This is particularly significant in light of the focus by the IRS and other governmental agencies on audits of tax-exempt entities.

In September 2009, the IRS made public its decision to begin a three-year employment tax audit of 6,000 companies in February 2010 which included tax-exempt entities.[28] This was recently confirmed by Faris Fink, IRS Small Business/Self-Employed Division deputy commissioner, who informally advised in late January 2010, that ''full-blown'' audits would begin ''around'' Feb. 15, 2010.[29] Although the majority of taxpayers would be small businesses, Fink noted that a variety of taxpayers would be examined (including tax-exempt entities) on various employment tax issues with a specific focus on officer compensation and fringe benefit programs.

In fact, tax-exempt entities have been on the IRS radar for several years as evidenced by a 2007 report entitled, ''Exempt Organizations Executive Compensation Compliance Program,'' in which the IRS reported its findings from a program designed to identify potential areas of abuse in compensation practices.[30] This initiative was comprised of a compliance check of 1,223 tax-exempt organizations and the subsequent examination of 782 tax-exempt organizations. As a result, more than $21 million was assessed against 40 ''disqualified persons'' or ''organization managers'' for violations which included:

- excessive salary and incentive compensation;
- payments for vacation homes, personal legal fees, or personal automobiles that were not reported as compensation;
- payments for personal meals and gifts to others on behalf of certain ''disqualified persons'' that were not reported as compensation; and
- payments to an officer's for-profit corporation in excess of the value of services provided by the corporation.

The IRS also noted in the report that future initiatives should focus on the correlation between satisfaction of the rebuttable presumption by an organization and the reasonableness of compensation paid to the disqualified person by such organization.

More recently, the IRS has targeted the review of compensation of hospital executives through its study of 20 nonprofit hospitals.[31] Finding that the average compensation was $1.4 million, the IRS found that although it appeared high, all amounts were supported pursuant to the rebuttable presumption process under current law. However, recognizing there might be a ''disconnect'' between what ''members of the public'' perceived was reasonable and what was permissible under the law, the IRS stated that it would ''continue its enforcement work in this area through examinations and other compliance initiatives.'' Thus, the IRS is likely to continue to increase audit activity in this area in the future.

In addition to increased federal audit activity, tax-exempt entities also are being targeted on a state level. Of particular interest is that the Massachusetts attorney general has recently announced that it will conduct periodic examinations of executive compensation practices, procedures and outcomes for public charities, *specifically large health care systems and health care*

exception if material changes are made to the contract, or the contract has impermissible provisions relating to its termination, extension or renewal. See Treas. Reg. § 53.4958-4(b)(2).

[26] This includes all cash and noncash compensation, bonuses, severance, certain liability insurance premiums, and all other compensatory benefits regardless of whether they are included in gross income (including payments to welfare benefit plans).

[27] If the entity fails to provide this contemporaneous substantiation, any services provided by the disqualified person will not be treated as provided in consideration for the economic benefit for purposes of determining the reasonableness of the transaction.

[28] ''IRS Will Begin Employment Tax Research Study in February 2010,'' Internal Revenue Service, Nov. 9, 2009.

[29] Stephen Joyce, NRP Employment Tax Exam Program To Launch Around Feb. 15, Fink Says, 29 *TM Weekly Report*, 142 (BNA) (Feb. 1, 2010).

[30] ''Report on Exempt Organizations Executive Compensation Compliance Project–Parts I and II,'' Internal Revenue Service, March 2007.

[31] ''Exempt Organizations Hospital Compliance Project Final Report,'' Internal Revenue Service, Feb. 13, 2009.

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insurers and based on that experience, the examination may be extended to other sectors.[32]

It is important to keep in mind that there are significant new reporting requirements for IRS Form 990, which became effective for the 2008 tax year, one of the purposes of which is to provide greater transparency of executive compensation. IRS Form 990 is publicly available, thus making any information on executive compensation of not-for-profit hospitals easily accessible. As new disclosure rules under IRS Form 990 are implemented, the disclosure of executive compensation based on its tax impact, as well as public opinion resulting from such disclosure, will influence the design of 457-(f) plans.[33] Since IRS Form 990 was recently revised to require increased disclosure regarding governance and executive compensation in the tax-exempt arena, payment of reasonable compensation also is subject to increased scrutiny.

Congress also has stepped up its effort to regulate tax-exempt entities. Sen. Charles Grassley (R-Iowa) has proposed amendments to recent health care legislation requiring additional governance and management information to be reported on IRS Form 990, as well as changes to Section 4958 of the code by removing the ''rebuttable presumption'' procedures safe-harbor by which a tax-exempt entity can demonstrate that compensation is reasonable. While these amendments were not presented for a vote, they demonstrate the continued focus in this area.

While Grassley's amendments did not become part of the recently enacted Patient Protection and Affordable Care Act, Congress's intent to further scrutinize hospitals and their practices is evident by the requirements in the new law that beginning Jan. 1, 2011, hospitals must demonstrate their charitable purpose by periodically conducting a community health needs assessment and meeting certain financial assistance policy, limits on charges, and billing and collection requirements in order to maintain or qualify for tax-exempt status.[34]

In sum, the increased federal and state investigation of executive compensation of tax-exempt entities and specifically of not-for-profit hospitals, makes compliance with the rules and regulations stated earlier in this article key for hospitals and their boards in 2010.

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In light of the increased transparency on the executive compensation practices of tax-exempt health care entities, not-for-profit hospitals must be mindful of the changing landscape as they establish and maintain executive compensation programs and report payments. Recent changes in the tax principles applicable to executive compensation of tax-exempt health care entities have limited the ability of not-for-profit hospitals to structure deferred compensation and retirement income programs for their executives. The IRS has made it clear that they will continue to focus on how not-for-profit hospitals demonstrate their qualification for tax-exempt status, as well as how they establish executive compensation, in an effort to curtail abuses by hospitals that pay excessive compensation. Since executive pay remains high despite adherence to existing laws and regulations in setting executives' pay, the IRS has embarked upon increased audit activity in this area and there is concern that the rebuttable presumption procedure may be revoked with the passage of future legislation. Despite these challenges, not-for-profit hospitals have an opportunity to review their existing executive compensation arrangements and structures and to develop new programs and approaches that meet the critical objectives of complying with legal requirements and providing appropriate incentives to their executives. Not-for-profit hospitals and their boards and advisers must pay close attention to the existing rules in order to adjust to impending changes and to make decisions that are in the best interests of the not-for-profit hospitals.

[32] Memorandum from David Spackman, chief of Not for Profit Organizations/Public Charities Division Office of Massachusetts Attorney General Martha Coakley to Massachusetts Hospital Association, Blue Cross and Blue Shield of Massachusetts, Harvard Pilgrim Health Care, Tufts Health Plan, and Fallon Health Plan.

[33] Under IRS Form 990, a 457-(f) plan taxable event will need to be reported as wages with respect to the executive, as well as specifically identified on Schedule J of IRS Form 990 as compensation includable by reason of Section 457(f) of the code. From a disclosure perspective, the total wages would increase, even though the executive may not be entitled to receive a distribution until a later time. Tax-exempt organizations that operate at least one hospital that is licensed, registered or similarly recognized by the state also must complete Schedule H of IRS Form 990, which requires disclosure of the hospital's charitable activities and provides a mechanism for the IRS to monitor compliance with the basic tenets of the hospital's tax-exempt status.

[34] Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 9007. 124 Stat. 737 (2010).