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IRS increases emphasis on not-for-profit health care

The IRS is scrutinizing the not-for-profit hospital sector. Healthcare financial managers should review developments as they occur.

In a significant development, the IRS has been focusing increased attention and resources this year on its oversight of the tax-exempt, not-for-profit healthcare sector. This attention is evident principally through increased audit activity, continued scrutiny of executive compensation practices, emphasis on transparency and Form 990 reporting, and new attention to corporate governance, corporate structure, and political activity.

This activity is taking place against a backdrop of general regulatory scrutiny of the not-for-profit sector, particularly skepticism that not-for-profit hospitals are increasingly indistinguishable from their for-profit counterparts, at least in terms of community benefit and charity care. The continued viability of the “community benefit standard” of tax-exempt status for healthcare entities remains much in doubt. Thus in many respects, the IRS’s increased level of oversight activity in 2007 reflects a broader policy mandate for compliance with tax exemption-related rules and regulations. The following discussion is intended to provide healthcare financial managers with a concise summary of “need to know” highlights of relevant 2007 IRS activities as they relate to not-for-profit health care.

The roots of the IRS’s increased activity can be traced to the Nov. 8, 2006, release of the agency’s work plan, “Exempt Organizations Implementing Guidelines for Fiscal Year 2007,” in which the IRS announced its major new projects and related initiatives for the tax-exempt sector for 2007. The work plan confirms the IRS’s focus for 2007 on:

- > Executive compensation
- > Differentiating for-profit from not-for-profit hospitals with respect to the appropriateness of tax-exempt status
- > The issuance of final regulations under the Intermediate Sanctions Excise Tax provisions of Code Sec. 4958
- > Guidance on the implementation of the Pension Protection Act of 2006
- > The tax-exempt status of community foundations

AT A GLANCE

In light of the increased attention the IRS is paying to not-for-profit organizations, healthcare financial managers should stay alert to developments regarding:

- > Community benefit standard
- > Executive compensation
- > Corporate governance
- > Transparency and Form 990
- > Political activity

The Community Benefit Standard

Congress continues to question the appropriateness of the current community benefit standard of tax-exempt status for hospitals. Sen. Charles E. Grassley, R-Iowa, has asked the Government Accountability Office (GAO) to evaluate how not-for-profit hospitals satisfy their requirement to provide community benefits as a basis for federal tax-exempt status and other tax benefits.^a In particular, Grassley has stressed his concern with what he described as the “vagueness” of the current standard and the wide discretion he believes hospitals may designate under community benefit. The specific issues he has asked the GAO to examine relate to state standards for community benefit; practices relating to uncompensated care, charity care, and bad debt; practices relating to community benefit other than uncompensated care; and the level of not-for-profit executive and board compensation and the extent to which these executives are involved in for-profit business ventures with not-for-profit hospitals.

Executive Compensation

The IRS continues to show strong interest in the executive compensation practices of tax-exempt healthcare organizations. The most significant related event this year to date is the March 1, 2007, release of the long-anticipated report summarizing the findings of its 2004-06 Executive Compensation Compliance Initiative. The report is noteworthy for the information it provides on the scope of the initiative, as well as for its specific findings (both favorable and unfavorable) concerning not-for-profit hospital practices. As such, it is important reading for financial managers, as well as for human resources executives and compensation committee members.

The IRS’s seriousness about this issue is well demonstrated by statistics in the report indicating that, among other things, the IRS has contacted more than 1,800 exempt organizations in recent years about their executive compensation

practices. These contacts occurred through two separate projects: approximately 1,000 correspondence-based “compliance checks” and almost 800 individual examinations. An additional 179 examinations were initiated due to “unsatisfactory responses” to the compliance checks.

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The report is also noteworthy for the observations drawn by the IRS from the compliance checks and examinations.

Unfavorable observations include the following:

- > Significant Form 990 reporting issues continue to exist.
- > Reporting problems appear to be the principal Form 990 issue; no other significant problems were identified.
- > A particularly problematic activity identified is the use of loans and unreported fringe benefits payable to “insiders.”
- > Intermediate sanctions excise taxes will be asserted by the IRS to address instances of allegedly excessive compensation.
- > Future executive compensation audits are likely to take the form of direct, on-site “field examinations” rather than correspondence-based compliance checks.
- > Many tax-exempt organizations do not attempt to qualify compensation arrangements for the “rebuttable presumption of reasonableness” safe harbor under the intermediate sanctions rules.

Favorable observations include the following:

- > Although the IRS will continue to monitor compensation practices, instances of excessive compensation were not as widespread as may have been expected.

a. “Grassley Wants GAO to Study Issues Involved in Hospitals’ Tax Exempt Status,” Bureau of National Affairs, Inc., *Health Care Daily Report*, April 6, 2007.

READ HFMA'S STATEMENT 15

HFMA's revised Principles and Practices Board Statement 15: *Valuation and Financial Statement Presentation of Charity Care and Bad Debts by Institutional Healthcare Providers* presents accounting guidance on the correct way to measure and report bad debt and charity care. Read the statement online at www.hfma.org/library. Click on "Accounting/Finance" and then on "Accounting & Financial Reporting"; then scroll down to the title.

- > The vast majority of exempt organizations exercise good faith with respect to tax-compliant compensation practices.
- > Strong comparability data and evidence of thorough approval processes are effective in demonstrating the reasonableness of compensation that might otherwise be regarded as high.

"Reading between the lines," the report offers exempt organizations a number of suggestions for improving compliance with tax rules relating to executive compensation, including:

- > The importance of a well-articulated compensation philosophy statement and compensation committee charter
- > The independence of the persons (board members and consultants) involved in the process
- > A clear rationale for the organization's philosophy regarding market placement
- > The use of a "tally sheet" (or close equivalent) to ensure appreciation by decision makers of all forms of compensation and benefits proposed to be paid to the executive
- > The particular importance of supporting documentation of high-profile items, such as loans, incentive plans, and discretionary awards

Recent comments by senior IRS officials make it clear that future exempt organization compliance activities will definitely include an executive compensation component.^b In addition, congressional scrutiny is focusing on the independence of compensation consultants and the role they play in what some allege are rising instances of excessive executive compensation.^c

Corporate Governance

This year, the IRS is also emphasizing the important role that effective corporate governance practices play in maintaining tax-exempt status. This area of emphasis is relatively new and significant for the IRS.

For example, in February 2007, a senior IRS official introduced proposed, suggested governance guidelines for Internal Revenue Code (IRC) Sec. 501(c)(3) organizations, including hospitals and health systems. The proposed guidelines present nine general elements of governance practice:

- > Adoption of a mission statement
- > Adoption of a code of ethics and whistleblower policies
- > Satisfaction of the duty of care/director diligence
- > Satisfaction of the duty of loyalty
- > Constituent transparency
- > Oversight of fund-raising activity
- > Stewardship of financial affairs
- > Payment of reasonable compensation
- > Adoption of a documentation policy

The expectation is that these proposed guidelines will help directors of exempt organizations understand and promote good governance.^d

Perhaps more significant are the April 26, 2007, remarks of IRS Commissioner Steven T. Miller regarding the relationship between corporate governance and tax-exempt status. Miller called the promotion of standards of good governance, management, and accountability a new "pillar" of the IRS's service and enforcement programs for exempt organizations. From his perspective, a well-governed organization is likely to be compliant with the conditions of tax exemption, while poor governance is more likely to lead to tax compliance problems. Accordingly, the IRS expects to "fill the vacuum" created by the absence of a federal counterpart to the governance oversight role of state charity officials.^e

Additional evidence of the emphasis on governance is reflected in the proposed revisions to the Form 990, particularly as they relate to conflicts of interest and business relationships shared between board members.

b. Stokeld, F., "IRS Exempt Organization Compliance Projects Will Address Compensation, Official Says," *Tax Analysts, Tax Notes*, May 31, 2007.

c. Hughes, M., and Sturges, P. M., "Congress Set to Review Consultants' Role in Excessive Pay, Conflicts of Interest Inquiry," Bureau of National Affairs, Inc., *Health Law Reporter*, May 31, 2007.

d. "IRS Official Speaks on Exempt Organization Issues," *Tax Analysts, Tax Notes*, May 1, 2007.

e. "IRS Official Speaks on Exempt Organization Issues," *Tax Analysts, Tax Notes*, April 26, 2007.

Transparency and Form 990

So far this year, there has been a substantial level of activity related to transparency and the Form 990. This activity comes “on top of” both significant policy focus on the importance of public disclosure by tax-exempt organizations and major changes to the Form 990 in recent years. Much of the recent focus on the Form 990 has been controversial, to the extent that it has addressed disclosure of compensation and business interests of “insiders” (e.g., officers and directors).

Early this year, the IRS announced a series of significant changes to the 2007 Form 990 (for returns covering fiscal years beginning in 2006). The revised Form 990 reflects changes in the following areas:

- > The definitions of family and business relationships of officers, directors, trustees, and key employees
- > New reporting of compensation and benefits payable to “insiders” (e.g., officers, directors, trustees, and key employees) from related organizations
- > New reporting of compensation and benefits payable to all other disqualified persons
- > New disclosure requirements (required by the Pension Protection Act of 2006) relating to transfers to and from controlled entities

The IRS’s release in April of frequently asked questions (FAQs) provides helpful clarity on a number of the issues associated with the 2006 Form 990. For example, two of the eight types of relationships that give rise to “related organizations” under line 75c for purposes of compensation disclosure have been deleted. The federal employer identification number of taxable related organizations submitted in response to line 75c need not be provided. Line 25c, reporting of loans and advances, relates to interest only and not to the underlying loan. Specific guidance is also provided on the proper reporting on line 75b of relationships among “insiders.”

Spreadsheets and other detailed information need not be provided in connection with reporting compensation and benefit expense on lines 25a, 25b, and/or 25c.

These clarifications notwithstanding, a clear message is that the IRS seeks to use the Form 990 as a means of learning more about the interests and relationships of board members of exempt organizations (presumably to identify the potential for conflicts and intraboard bias).

Most noteworthy has been the June 14 release, in draft form, of a substantially revised Form 990 (including schedules and instructions) to be used for fiscal years beginning in 2008. Implementation of this revised Form 990 is likely to result in more significant reporting obligations for tax-exempt hospitals and health systems.

A principal feature of the draft revised Form 990 is the use of a basic set of questions to be answered by all organizations, with reliance on individual schedules to elicit information on specific (and in certain instances, industry-specific) issues. Examples include schedules focusing on community benefit and charity care practices; executive compensation details regarding loans, executive perquisites, deferred compensation, and other retirement benefits; related organizations (including intrasystem funds flow); and corporate governance practices.

In final form, the revised Form 990 will provide regulators, constituents, and the media with a dramatically increased reservoir of information regarding the activities of tax-exempt hospitals and health systems. In that respect, it is consistent with the request of the Senate Finance Committee leadership that the IRS update the Form 990 to provide access to additional information concerning the “operational complexities” of hospitals, among other tax-exempt organizations.^f

Along the same lines, the IRS issued guidance on its interpretation of the Pension Protection Act of 2006 requirement that IRC Sec. 501(c)(3) organizations make their Form 990-T publicly

^f “Senate Finance Leaders Want Tax Form for Non-Profit Sector to Offer ‘Transparency,’” Bureau of National Affairs, Inc., *Health Care Daily Report*, May 31, 2007.

available. The notice provides, in essence, that certain organizations not required to file a Form 990 (e.g., churches and state colleges and universities) must make their Form 990-T available, if they have one.

Improper Political Activity

The IRS also recently provided guidance with respect to the political campaign activities of exempt organizations. The guidance, issued in the form of a revenue ruling, provides guidelines on the scope of the tax law prohibition of certain types of political campaign activity by 501(c)(3) organizations (including hospitals and health systems), and of activities that may constitute prohibited campaign intervention. The guidance is provided principally through 21 fact patterns describing certain levels of political activity or campaign intervention and evaluating whether in each instance prohibited activity has (or has not) occurred.

At the same time, the IRS released its *Report on the Political Activity Compliance Initiative* for the 2006 election cycle. This report offers a glimpse into the IRS's historical enforcement activity with respect to improper political activity.

Remain Alert

A significant level of IRS activity has occurred during the first half of 2007 with respect to the oversight of 501(c)(3) organizations, such as hospitals and health systems. The IRS's interest in such topics as the community benefit standard,

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executive compensation, corporate governance, transparency and the Form 990, and political campaign activity is consistent with both its work plan and public policy calling for increased scrutiny of the tax-exempt sector. Accordingly, healthcare financial managers are well-advised to review these developments, make appropriate compliance-related adjustments, and remain alert for further IRS activity. ●

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