



IRS Issues Detailed Report On Results Of Executive Compensation Initiative

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On March 1, the Internal Revenue Service (IRS) released an important and long-awaited new report on the executive compensation practices of tax exempt organizations, including hospitals and health systems (Report). The specific purpose of the Report was to summarize the findings and conclusions from the IRS' Executive Compensation Compliance Initiative during 2004-2006 (Initiative). The Report contains many significant findings, both positive and negative. As such, it offers important guidance for the executive compensation committees, senior executive leadership, and compensation counsel of tax exempt hospitals.

Scope of the Initiative

With so much focus in recent years on "good governance" and other corporate responsibility issues, there has been an understandable tendency among some boards to underestimate the interest of the IRS on executive compensation matters. Yet, the Report makes it very clear that the IRS has devoted substantial resources to its Initiative over the last several years and, given the results, can be expected to continue to do so for the foreseeable future. Indeed, the Report indicates that the IRS contacted over 1,800 exempt organizations about their executive compensation practices, in two separate projects (compliance checks and actual examinations). The unmistakable message to compensation committees and executive leadership is that the IRS takes very seriously the manner in which tax exempt organizations prepare, approve, and report executive compensation arrangements. Thus, close attention to related compliance by these committees in the compensation review process is exceedingly important, and may prevent subsequent distracting and expensive inquiries from the IRS.

What the IRS Found

Through its many compliance checks and examinations, the IRS reached the following conclusions and observations--including some surprisingly favorable ones.

"Negative" observations included the following:

- Many organizations are encountering substantial difficulty in understanding and applying the Form 990 disclosure rules.
- A significant number of Form 990s contained material errors and omissions (a fact that was quickly seized upon by Senate Finance Committee leadership).
- Loans and unreported fringe benefits payable to executives and other "insiders" can be problematic.
- The IRS is willing to seek application of intermediate sanctions excise taxes to "insiders" involved in the payment of allegedly excess compensation.

- Almost half of the contacted organizations failed to attempt to satisfy the “Rebuttable Presumption of Reasonableness.”
- Direct “field” examinations, as opposed to correspondence-based compliance checks, are more effective in addressing executive compensation issues and will be used more frequently by the IRS going forward.

“*Positive*” observations included the following:

- The instances of excessive compensation paid are not widespread (although they are sufficiently significant to warrant continued close IRS scrutiny).
- The vast majority of exempt organizations take their compensation obligations seriously.
- In many instances, compensation that might be regarded by the public as “high” or even “excessive” was justified as reasonable by the organization on the basis of the organization’s substantial process and effective use of comparability data.

Report “Takeaways”

Executive compensation committees, CEOs, and their compensation advisors may wish to consider the following practical guidelines in response to the Report (and related Congressional reaction):

- ***Guiding Documents.*** Assure that the committee is guided by a well-articulated executive compensation philosophy statement and by a committee charter. These documents should provide continuity of guiding principles from one meeting to the next, from one year to the next, and from one committee to the next.
- ***Tally Sheets.*** Assure by the use of “tally sheets” (or a close equivalent) that the committee is aware of, and takes into account in assessing reasonableness, all forms of compensation and benefits provided to the group of executives being reviewed. The tally sheets should show all current costs and values of compensation and benefit arrangements, as well as the future cost and value of compensation and benefit arrangements.
- ***Rationale for Market Placement.*** State on the record why the organization’s philosophy, and why the approved decisions of the committee, involve pegging executive compensation to a particular percentile of the marketplace (i.e., the peer group used for comparison). In other words, why does the organization intentionally manage to the 75th percentile of the market?
- ***High Profile Items.*** Assure that the organization provides no “high profile” compensation or benefit items that have not been approved, of which the board or committee is unaware, or that would cause embarrassment if and when made public.
- ***Clean Up Loans.*** Because of the high profile of loans to insiders, consider cleaning up loans by arranging for a payoff of the remaining principal balance. At a minimum, review all outstanding loans to be sure that all loans are being repaid and otherwise administered in accordance with their terms.
- ***Expense Reimbursements.*** Take a careful look at executive expense payments and reimbursements to assure (a) proper tax treatment, (b) appropriate internal financial controls, and

(c) compliance with Form 990 reporting rules. Take steps to make sure that the organization does not permit payment or reimbursement of expenses that fall outside corporate policy guidelines, or that would not be considered “ordinary and necessary” business expenses under tax law guidelines.

- **Conflicts of Interest.** Move toward a “cleaner” compensation committee consisting of board members who are less likely to have, or be perceived as having, a potentially conflicting financial or relationship interest. Consider requiring that all committee members have no business relationship with the organization or its affiliates. Make sure that, when the compensation committee engages in final deliberations and the approval process, any interested party is excused from the meeting, and that the recusal is noted in meeting minutes.
- **Documented Rationale.** Fully document the rationale for all key decisions and elements of the executive compensation review and approval process, including (a) the peer group used for comparison, (b) where the organization pegs itself to the market, (c) all elements of pay and benefits provided and reviewed, (d) the expected and potential size of total retirement benefits, (e) the establishment of a supplemental retirement program later in an executive’s career, and (f) each specific compensation decision.
- **Incentive Plans.** Take a more active role in evaluating annual and long term incentive compensation arrangements by understanding how performance goals are set and measured, by understanding how the goals and performance compare to the performance of the organization’s peer group, by creating an appropriate quantitative and qualitative distinction between annual and long term performance measures, and by holding the line against “after the fact” changes and enhancements.
- **Rebuttable Presumption Position.** Approach the rebuttable presumption as a “sliding scale” – the higher the compensation in relation to market, the stronger the documented process and rationale needs to be.
- **SERPs.** Conduct an assessment of SERPs and other retirement supplements in a manner that includes the following steps: (a) understand the full current value and the full potential value, (b) determine whether they provide the intended benefit, (c) assure that they are reported in timely and complete manner on Form 990, and (d) comply with the Section 409A rules for nonqualified deferred compensation arrangements.
- **Form 990 “Message.”** Use a coordinated internal approach to satisfy the Form 990 reporting requirements in a manner that sends a well-crafted message to the public concerning community benefit, charity care, the use of exempt assets, and the role of executive compensation and benefits in that context.
- **Informing Full Board.** Provide sufficient information to the full board concerning the executive compensation review and approval process, and perhaps with respect to the decisions and pay elements themselves, to the extent necessary to satisfy the board’s oversight responsibilities.
- **Media Strategy.** Prepare for media inquiries on executive compensation and benefits by crafting a public relations strategy, appointing and preparing a media spokesperson, and having available appropriate supporting materials and facts.

Conclusion

The release of the Report is a significant development with respect to regulatory oversight of executive compensation practices of exempt organizations such as hospitals and health systems. As such, it should be given close consideration by CEOs, board compensation committees, and the board's compensation advisors.

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