



Compensation Insight

IRS Releases Detailed Report on Results of Executive Compensation Compliance Initiative

The IRS recently released an important and long-awaited report on the executive compensation practices of not-for-profit organizations, including hospitals and healthcare systems. The IRS Executive Compensation Compliance Initiative, conducted from 2004-2006, reviewed the executive compensation practices of more than 1,800 tax-exempt organizations.

For board members of not-for-profit organizations, interpreting the regulations related to executive compensation can be a challenge. Findings from this important report may not answer all of your questions, but they should help you better understand the current regulatory environment for executive compensation and also shed some light on future initiatives.

Report Findings and Recommendations

The IRS offered the following observations and conclusions, including some surprisingly favorable findings.

Subject	IRS Findings	IRS Recommendations
Overall Findings	<ul style="list-style-type: none">• Most organizations take their compensation obligations seriously.• Instances of excessive compensation were not widespread.• The IRS is willing to impose excise taxes. More than \$21 million was imposed on 25 organizations and against 40 disqualified persons.¹	Correspondence-based compliance checks should not be the exclusive method for conducting these examinations. Future examinations will include advance visits or other methods of contact.

1. The issues included: compensation deemed excessive, payments for vacation homes, personal legal fees, automobiles, personal meals and gifts not reported as compensation, and payments to an officer's for-profit corporation in excess of the value of services provided.

Subject	IRS Findings	IRS Recommendations
Compliance with Intermediate Sanctions Guidelines	<ul style="list-style-type: none"> • Only 51% of the contacted organizations attempted to satisfy in full the “Rebuttable Presumption of Reasonableness,” which specifies that: <ul style="list-style-type: none"> > An entirely independent governing body must review and approve compensation for disqualified individuals. > The body must rely on comparable data prior to making decisions. > Decisions must be adequately documented. 	Additional education and guidance about the guidelines for tax-exempt organizations and agents are needed.
Form 990 Reporting	<ul style="list-style-type: none"> • Many organizations are having substantial difficulty understanding and applying Form 990 disclosure rules. • A significant number of material errors and omissions were found. In fact, more than 30% of the organizations needed to amend their Form 990s. 	Form 990 reporting is being revised to provide clearer instructions for specific data requirements.
Loans and Other Fringe Benefits	<ul style="list-style-type: none"> • Loans and unreported fringe benefits payable to executives and other “insiders” can be problematic. 	An additional examination project has been initiated to focus on executive loans.

What Does This Mean for Your Organization?

Board committees responsible for executive compensation should carefully review the governance oversight and reporting of executive compensation programs and practices. The following guidelines provide assistance:

Guidelines for the Compensation Committee to Consider

Area	Guidelines
Compensation Committee Composition	<ul style="list-style-type: none"> • Ensure that the committee responsible for executive compensation decision-making consists entirely of board members who do not have a potential conflict of interest. • If a conflict of interest arises for a committee member, excuse the member when addressing compensation of anyone with respect to whom the member has a potential conflict.
Guiding Documents	<ul style="list-style-type: none"> • Make sure the committee is guided by a well-articulated philosophy statement that specifies the parameters for executive compensation decision-making. • Establish a charter statement that specifies the committee’s roles and responsibilities.
Tally Sheets	<ul style="list-style-type: none"> • Use “tally sheets” to summarize total employer costs associated with all forms of compensation and benefits provided to executives.

Area	Guidelines
Rebuttable Presumption of Reasonableness	<ul style="list-style-type: none"> • Approach the rebuttable presumption as a “sliding scale.” • The higher the compensation in relation to market levels, the stronger the documentation process and rationale need to be.
Documentation	<ul style="list-style-type: none"> • Document the rationale for all key decisions and elements of the executive compensation review and approval process.
Form 990 Reporting	<ul style="list-style-type: none"> • Ensure that Form 990 reporting is accurate. • Consider providing information on your organization’s executive compensation decision-making process on the Form 990.
Informing the Full Board	<ul style="list-style-type: none"> • Provide sufficient information to the full board concerning the executive compensation review and approval process so board members are not surprised by Form 990 reporting.
Media Strategy	<ul style="list-style-type: none"> • Prepare for media inquiries on executive compensation. • Craft a detailed public relations strategy, and appoint and thoroughly prepare a media spokesperson.

Guidelines for Specific Compensation Elements

Area	Guidelines
High-Profile Compensation Components (e.g., loans, housing, spouse travel, etc.)	<ul style="list-style-type: none"> • Ensure that the committee has approved all “high-profile” compensation or benefit items and that board members are aware of each item. • Consider eliminating high-profile components of executive compensation.
Loans	<ul style="list-style-type: none"> • Carefully monitor all loans and ensure that they are being repaid and administered according to their terms. • Consider eliminating loans due to their controversial nature and associated scrutiny.
Supplemental Executive Retirement Plans/ Deferred Compensation	<ul style="list-style-type: none"> • Make sure the committee understands the value of SERPs/ deferred compensation. • Report all SERPs/deferred compensation appropriately on Form 990. • Ensure that all plans comply with Section 409A rules.
Incentive Plans	<ul style="list-style-type: none"> • Mandate committee involvement in evaluating executive incentive compensation arrangements, including establishment of performance goals. • Hold the line against “after-the-fact” changes and enhancements.
Expense Reimbursement	<ul style="list-style-type: none"> • Ensure a strict policy for reporting and reimbursing executive expenses. • Eliminate any expenses that do not have specific business purposes.

Throughout this process, the unequivocal message to board committees is that the IRS takes very seriously the manner in which not-for-profit organizations develop, approve and report executive compensation arrangements. Therefore, close attention to compliance details is increasingly important and can help prevent IRS inquiries. For further assistance, contact your Sullivan-Cotter consultant today.

About Sullivan, Cotter and Associates, Inc.

Since 1992, SullivanCotter's innovative yet practical compensation solutions have created tremendous value for the healthcare organizations it serves. In this capacity, SullivanCotter specializes in the development and implementation of strategic compensation and reward programs for its healthcare clients.

As a leader in healthcare executive, physician and employee compensation consulting, SullivanCotter has served many of the nation's leading and largest health systems, academic medical centers and community healthcare organizations and has developed some of the top healthcare compensation surveys in the United States.

SullivanCotter strives to help our healthcare clients develop and implement creative, comprehensive and compliant compensation programs that bridge the needs of organizational stakeholders.

SullivanCotter has offices in Atlanta, Boston, Chicago, Dallas, Denver, Detroit, New York, Parsippany, San Francisco and Westport.

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About McDermott Will & Emery LLP

With an over 50-year history of serving the healthcare industry, McDermott Will & Emery has one of the United States' largest and most prestigious health law departments.

The American Lawyer rated the health law practice No. 1 in the United States in its most recent rankings. *Chambers USA: America's Leading Lawyers For Business, 2006 Client's Guide* ranked the health law practice in the top tier of all such practices nationwide.

McDermott Will & Emery provides advice on all aspects of executive compensation, including benefits, tax, securities, labor and litigation issues. Members of the Executive Compensation Group include former IRS officials who participated in many of the rulings and regulations affecting the executive compensation area and attorneys who have leadership positions within the bar.

McDermott Will & Emery's health lawyers are resident in the firm's Boston, Chicago, Los Angeles, Miami, New York and Washington, D.C. offices.

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