The Timing Seems Right for the IRS to Re-examine Executive Compensation Rules for Tax-exempt Organizations

***By Guest Blogger*: Don Quigley, Retired Chief Legal Officer for an East Coast Health System**

The Source Blog recently noted the SEC action in August finally adopting the executive compensation disclosure rule mandated by the Dodd-Frank reform statute enacted five years earlier. The disclosure rule requires most public companies to disclose to shareholders the total compensation of their CEOs along with a ratio of such compensation to the median employee compensation. The Source questioned whether the effect of the rule will reduce the incidence of exorbitant CEO pay packages and have a spill-over slowing effect on average executive compensation increases in the nonprofit sector. A separate question raised here is whether the IRS should examine its own rules on executive compensation for tax-exempt organizations since many assert its prior actions have contributed to escalating compensation paid nonprofit hospital executives. The timing seems right for the IRS to do so.

Purpose of Disclosure

The premise behind the Dodd-Frank and SEC rule is that disclosing some measure of compensation directly to shareholders in annual proxy statements may have an effect on judgments by governing boards about reasonableness of high compensation and benefit awards being paid. The IRS has long required but not solely relied upon disclosure of CEO compensation on publicly

available 990 tax returns of tax-exempt organizations classified as charities under 501(c)(3) and (4). Since 2008 the requirement has applied to all of the approximate 1.5 million tax-exempt organizations except those now with annual gross receipts below $200,000 and total assets below $500,000. Since most nonprofit hospitals, non-governmental colleges and universities, and private foundations are exempt under 501(c)(3) tax return rules apply to all their directors and officers, as well as other influential insiders. Disclosure in the health care sector, often well-publicized, has demonstrated a “rising tide” cited in the prior blog and in part due to other IRS action.

Historical Background

In 1996, the Taxpayer Bill of Rights 2 statute was enacted and included the historic Excess Benefits law or Intermediate Sanctions law in I.R.C. section 4958. The section was intended to empower IRS to enforce better the long-standing prohibition on private inurement of benefits to insiders authorizing potential significant taxes being imposed on recipients, “disqualified persons,” and approving managers for such benefits exceeding the fair market value of the services or goods provided by the individuals receiving such payments. Five years later, the IRS issued temporary regulations, made final one year later, creating a rebuttable presumption of reasonableness for compensation and benefits paid to disqualified persons if the total were set by a process meeting three standards: the total was (l) based on comparability or market data, (2) approved by a fully independent group – the board or other body authorized by it, and (3) supported by contemporaneous documentation of the deliberations and the decision. The proposed process to obtain the IRS presumption has been widely adopted by tax-exempt health care organizations.

During 2006, over thirty highly publicized hearings before the

Senate Finance Committee on tax-exempt hospital practices, under Chairman Grassley, concerns were expressed often with executive compensation levels and the need for transparency. The Committee concluded the process focused on the need for more community benefits, more charity care, and changes in certain debt collection practices. The Senators pressed Secretary of the Treasury Paulson to have the IRS address the issues cited. The IRS responded in several ways: an extensive survey of tax-exempt hospitals, new requirements on community benefits and charity care, and a new 990 tax return, including a new schedule for hospitals beginning in 2008. No change, however, was made in the regulation describing the process for establishing insider compensation.

In 2009 the IRS published The Exempt Organization Hospital Compliance Project Final Report that included results from studying over 500 tax-exempt hospital detailed surveys and 20 examined 990 tax returns. The report concluded that executive compensation appeared to be high but appeared supported under current law. Why? Almost all surveyed and examined hospitals used market data for setting such compensation and most followed the process to get the presumption. The Report conceded, however, that there had been no apparent effect on slowing the growth of such compensation since the rule was adopted eight years prior and that further oversight was warranted. Notwithstanding, no action to address the topic has been taken since that report.

Current State of Affairs

While the Great Recession moderated compensation increases for a brief time, the earlier trend has returned. Modern Healthcare published on August 5, 2015 its annual report on health care executive compensation. In the last year, CEO compensation for tax-exempt health systems increased by an average of 8.2% while

system hospital CEO compensation increased by an average of 6.5%. Those increases were three to four times the average increases awarded hospital employees.

Just as public companies resisted the SEC disclosure rule, arguing the need to be market competitive, health care leaders may well argue for the same need accentuated by widespread, well-documented market data that cannot be ignored for executive recruitment and retention. Health care leaders may also resist further guidance from IRS noting IRS already provides much tighter oversight of executive compensation than required with the SEC disclosure rule. Note the constraints on the tax-exempt leadership compensation that public companies avoid in establishing compensation for their leaders: (1) There is no market data requirement for establishing executive compensation for organizations not tax-exempt|(2) There is no penalty or special tax for excessive amounts paid CEOs of public companies|(3) There is no potential penalty for board members of public companies who approve excessive pay|and (4) Only CEOs of public companies need compensation measures reported while all executives and other insiders of tax-exempt organizations are subject to the IRS constraints. Re-examining exempt organization leaders' compensation, however, may not slow future increases any more than transparency has done but future increases may be based more on leadership effecting improved organizational performance rather than market data alone.

The SEC is relying upon transparency to produce change. Just as the Hawthorne effect has been shown to be absent in many business settings, the IRS rule may have increased transparency of nonprofit health care executive compensation but has fostered greater increases than would have occurred without the sophisticated survey tools and data produced by HR consulting firms in the last fifteen years.

Recommendations and Conclusions

The system and use of market data will not cease|nonetheless, the IRS may well add measures or other standards concerning organizational performance besides the latest consultant's market survey report now routinely used. Perhaps those standards should measure organizational performance in establishing future base compensation and bonuses with both upside and downside risk rather than simply the size of the annual bonus – now the common practice. Cost and quality may also need consideration|simply using excess of revenue over expense for financial performance is akin to the criticized excessive use of "shareholder value" to justify extraordinary payments for public company CEOs. The IRS may learn from the experience of CMS in implementing measures for both increased hospital payments (Value-Based Purchasing program using 70% Clinical Process measures and 30% Patient Experience of Care Surveys) and payment reductions for early readmissions and hospital-acquired conditions services.

The IRS noted in the 2009 Final Report that the issue of executive pay is challenging. Prescribed models and measures from IRS are neither practical nor likely but inducing some change from the inflationary system its rule created may do more than save tiny amounts of health care expenses from better controlling executive compensation. The IRS can focus health care leadership more acutely on cost, quality and community benefits. The common practice of nonprofit hospital governing boards to rely on the process urged by the IRS regulation demonstrates nonprofit community leaders serving as trustees are motivated to do the right thing. Unfortunately, they have simply been directed to follow a specific market driven method for establishing pay for executive performance. The timing seems right for the IRS to encourage new approaches.