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# Executive Compensation in Nonprofit Health Care Organizations: Who's in Charge ?

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# EXECUTIVE COMPENSATION IN NONPROFIT HEALTH CARE ORGANIZATIONS: WHO'S IN CHARGE?

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Press reports about executive compensation levels at nonprofit organizations in general, and health care organizations in particular, have sounded alarms and calls for reform. The headlines of these reports give a fair indication of what's inside: "Rolling in Dough,"[1] "Some Officers of Charities Steer Assets to Selves,"[2] and "Scales Tipping Against Tax Exempt Hospitals."[3] The message of these articles is clear – nonprofit health care executives get paid too much. But the truth of the message is far more difficult to ascertain.

Some officers of nonprofit health care organizations are no doubt "overcompensated," that is, the boards of trustees could have found individuals of comparable skill and experience to perform the same duties for less compensation. Many officers of nonprofit health care organizations, however, are probably "undercompensated," that is, these officers could obtain significantly higher pay, including some form of equity compensation such as stock options, in the private health care sector. These two end results – overcompensation and undercompensation – are the inevitable consequence of the push and pull of the compensation-setting process. While it is clearly the duty of charitable trustees to exercise reasonable care to avoid overcompensating officers, it is perfectly understandable that a hospital executive would ask to be paid the market rate for an employee of his or her

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1 Vince Galloro & Laura B. Benko, *Rolling in Dough*, MOD. HEALTHCARE, Aug. 2, 2004, at 6 (discussing the high level of compensation for CEOs and increased scrutiny that health care organizations are receiving).

2 Beth Healy et al., *Some Officers of Charities Steer Assets to Selves*, BOSTON GLOBE, Oct. 9, 2003, at A1 (discussing how officers of private charities foundations receive excessive salaries).

3 Julie Appleby, *Scales Tipping Against Tax-Exempt Hospitals*, USA TODAY, Aug. 8, 2004, at 1B (reporting on the criticisms aimed at not-for-profit hospitals for high salaries given to executives, high charges and collection methods used against uninsured patients).

skills and level of responsibility. This is precisely how the free market for executive talent ought to work and it should not be a cause for despair if the end result is sometimes a bit too high or too low – if permitted to function freely the market will adjust itself over time. As described below, "functioning freely," includes an open and transparent compensation-setting process in which a number of interested parties have a voice.

This paper discusses the various parties that have direct or indirect roles in the compensation-setting process for officers of health care organizations. The boards of trustees and the officers in question obviously have a direct role in negotiating the compensation package. In addition to the officer in question and the board of trustees, however, donors, patients, and federal, state and local governments, all have important roles to play. Donors exercise control by choosing to make or withhold contributions. Patients exercise some degree of market control if they are able to choose where (and by whom) health care services are provided. Federal, state and local governments, hopefully reflecting the interests and sentiments of the public, have two principal tools at their disposal: (1) more aggressive enforcement of existing law, and (2) the enactment of new legislation.

This paper concludes that additional legislation is not needed at the present time in order to ensure that nonprofit health care executives are fairly, but not excessively, compensated. Rather, if each of the stakeholders described above carries out its respective role, an appropriate balance will be struck and hospital officers will be appropriately compensated. While instances of apparent overcompensation may at times arise, existing enforcement tools and market pressures should provide a sufficient dampening effect. By contrast, legislation seeking to "cap" hospital salaries or to otherwise limit available benefits would be counter-productive and could potentially drive away talented individuals from the nonprofit health care world.[4]

While the role of each of these stakeholders is critical, much of the emphasis in this paper will be on the role of the IRS. The IRS has recently announced a broad series of compensation audits, and the conduct and resolution of these audits will have a significant impact on compensation setting in the nonprofit sector.[5]

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[4] *Tax Exempt Governance Proposals: Staff Discussion Draft of the Senate Committee on Finance*, 108th Cong. (2004), *available at* http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf (suggesting a cap on salaries, among other proposals). JOINT COMM'N ON TAXATION, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, JCS-02-05 (2005) *available at* http://www.house.gov/jct/s-2-05.pdf (among other proposals, expand and make the I.R.C. § 4958 "intermediate sanctions" rules more harsh).

[5] INTERNAL REVENUE SERVICE, IRS INITIATIVE WILL SCRUTINIZE EO

## WHAT'S NEW?

The observation that various parties have an interest in the activities of charitable organizations and have some ability to influence those activities is not surprising. Against the backdrop of a number of compensation "scandals" during the past ten to fifteen years in the nonprofit sector,[6] there have been several important developments that enable each of the stakeholders listed above to better carry out its role in the compensation-setting process at nonprofit hospitals and other health care organizations. These include the ready availability of compensation data on the Internet, the enactment of the so-called "intermediate sanctions" rules, the enactment of the Sarbanes-Oxley legislation that shines a spotlight on board members' fiduciary obligations, and the emergence of a number of compensation factors unique to nonprofit health care organizations.

### I. The Information Revolution

The Internet has completely changed the ability of various nongovernmental stakeholders in charitable organizations to play a meaningful and informed role in overseeing such organizations. The leading provider of Internet-based information about charities is GuideStar, itself a tax-exempt organization, whose stated goal is "to revolutionize philanthropy and nonprofit practice with information."[7] By providing ready access to IRS Forms 990 for more than a million nonprofit organizations, combined with comparative data assembled

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COMPENSATION PRACTICES, *at* http://www.irs.gov/newsroom/article/0,,id=128328,00.html (Aug. 10, 2004).

[6] For examples of compensation scandals, see e.g., Aramony v. United Way of America, 28 F. Supp. 2d 147 (S.D.N.Y. 1998) (discussing the extent to which former president Aramony was entitled to benefits under the United Way's benefits plan in light of the fact that Aramony breached his fiduciary duty to the corporation); William L. Gardner & Emmett B. Lewis, *Ethical Considerations When Representing Non-Profit and Tax-Exempt Organizations*, REPRESENTING & MANAGING TAX-EXEMPT ORGANIZATIONS at 1-2 (Georgetown University Law Center Continuing Legal Education, Apr. 26-27, 2001) (commenting on the excessive compensation given to the trustees of the Bishop Estate); Sacha Pfeiffer & Beth Healy, *Foundations' Tax Returns Left Unchecked,* BOSTON GLOBE, Dec. 29, 2003, at A1 (highlighting the lack of oversight associated with the tax returns of charitable foundations); Marcella Bombardieri & Walter V. Robinson, *Wealthiest Nonprofits Favored by Foundations*, BOSTON GLOBE, Jan. 11, 2004, at A1 (describing favoritism towards certain non-profits that are not particularly needy); Beth Healy & Walter V. Robinson, *GE Sent Funds to Five Directors' Foundations*, BOSTON GLOBE, Jan. 20, 2004, at F1 (explaining that GE has repeatedly made large donations to former directors' private foundations for the purpose of bolstering the reputation of the directors).

[7] GUIDESTAR, *Frequently Asked Questions, at* http://www.guidestar.org (last visited Feb. 13, 2005).

for different types and sizes of nonprofit organizations, GuideStar facilitates the analysis of executive compensation within the nonprofit sector.[8] It is a simple matter, for example, for a nonprofit community hospital to ascertain the compensation levels paid by its main competitors, as well as that of similar-sized hospitals throughout the country. It is also a simple matter for a potential donor or patient of a hospital to access this same information.

State charity regulators have also made huge strides in making information about charities freely available to the public. A number of states have their own information return for charitable organizations and make that return, as well as the IRS Form 990, easily available through an on-line search or by visiting their offices.[9]

While there is no shortage of information available about nonprofit organizations, including compensation levels, it is the responsibility of those who seek to monitor and influence such organizations to examine such information. It is likely that a significant portion of the available information is incorrect, missing, or inconsistently reported. It is for this reason that the first task of the current IRS compensation audits will likely be to ascertain the accuracy and completeness of information made available on the IRS Form 990.[10] The IRS should then use a combination of targeted enforcement efforts, educational outreach, and possibly modifications to the Form 990 in an effort to improve the quality of publicly-available information. Even if the IRS does not prosecute a single "excess benefit" case under the intermediate sanctions rules discussed below, its efforts will have been successful if it is able to significantly improve the quality and consistency of information made available to the public.

## II. Intermediate Sanctions

The "intermediate sanctions" rules, which are contained in § 4958 of the Internal Revenue Code of 1986, as amended (the Code), were enacted as part of the Taxpayer Bill of Rights 2, which President Clinton signed into law on July 30, 1996.[11] Final Treasury regulations implementing § 4958 became effective on January 23, 2002.[12] Sec-

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[8] *Id.*

[9] *E.g.*, FOUNDATION CENTER, "Can Nonprofit Organizations file IRS Form 990 Electronically?" http://fdncenter.org/learn/faqs/html/990_electronic.html.

[10] The IRS has indicated that it is will contact approximately 2,000 nonprofit organizations by 2005 to verify amounts reported on Form 990. INTERNAL REVENUE SERVICE, IRS INITIATIVE WILL SCRUTINIZE EO COMPENSATION PRACTICES, *at* http://www.irs.gov/newsroom/article/0,,id=128328,00.html (Aug. 10, 2004).

[11] Pub. L. No. 104-168, 110 Stat. 1452 (1996).

[12] Excise Taxes on Excess Benefit Transactions, 67 Fed. Reg. 3076 (Jan. 23, 2002) (codified at 26 C.F.R. pt. 53, pt. 301, and pt. 602).

tion 4958 was intended to provide the IRS with a lesser remedy than revocation of tax-exempt status in instances of private inurement – hence the colloquial name "intermediate" sanctions.[13] Previously, if an exempt organization allowed any part of its net earnings to inure to the benefit of a private individual (the so-called private inurement doctrine) the IRS had only a single option: to revoke the entity's tax exempt status. Because this penalty was so severe and was not targeted at the individuals who were responsible for the private inurement, it was seldom used and was therefore thought to be an ineffective enforcement tool.[14]

Section 4958 provides that when a *disqualified person* engages in an *excess benefit transaction* with an *applicable tax-exempt organization*, both the disqualified person and any *organization manager* who *knowingly participates* in the transaction will be liable for excise taxes:[15] a veritable wonderland of defined terms. While each of the defined terms is the subject of a fairly nuanced definition, the issue often boils down to "did the organization pay its CEO (or other organization insider) too much?"[16] A hospital described in § 501(c)(3) of the Code is clearly an "applicable tax exempt organization," the president and other key hospital officers are "disqualified persons" and the members of the board of trustees (or board subcommittee responsible for setting compensation) are "organization managers" who

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[13] WILLIAM ARCHER, TAXPAYER BILL OF RIGHTS 2, H.R. REP. NO.104 –506 at 59 n.15 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1143, 1182 n.15.

[14] The *in terrorem* effect of threatened loss of tax exempt status should not be understated, however, and such threat is periodically used by the IRS to persuade exempt organizations to enter into closing agreements that often require monetary penalties and a change of governance procedures.

[15] Treas. Reg. § 53.4958-1(a) (2002).

[16] The issue of what constitutes reasonable compensation, central to the intermediate sanctions rules, is hardly a new one for tax practitioners. Section 162(a)(1) of the Code limits a business's deduction for compensation to a "reasonable allowance." Closely held corporations have an incentive to overpay their controlling shareholders, however, in order to avoid the corporate level of tax incurred on earnings and profits used to fund non-deductible dividends. Hence an excessive salary can constitute a disguised dividend to the employee. Because charitable organizations are expressly forbidden to pay dividends to any private party because of the prohibition on private inurement found in Code § 501(c)(3), the case law under Code § 162(a)(1) for determining what is reasonable compensation should prove instructive, perhaps even controlling, in the context of § 4958. In this regard, it is not comforting (nor surprising) that a recent commentator described the current "multifactor test" of reasonable compensation under Code § 162(a)(1) as "unpredictable and equivocal" with the outcome of cases "necessarily determined by subjective judicial judgment and arbitrary decision-making." *See* Jason L. Behrens, *What is Reasonable Compensation for Deduction Purposes? Two Tests Exist But Neither Paints a Clear Picture, as Evidenced in* Devine Bros. v. Commissioner, 57 TAX LAW., 793, 799-800 (2004).

"knowingly" approve compensation.[17] This leaves only the question of whether an "excess benefit transaction" has occurred (the "too much pay?" question).

The passage of the intermediate sanctions legislation in 1996 created some confusion and consternation among tax-exempt organizations. While the confusion is not surprising, the consternation is often out of proportion to the impact of the new rules. Although the IRS has been given a new enforcement tool, many exempt organizations will now face a *reduced* risk of loss of tax exemption because of the payment of excess compensation and, in addition, are given a "safe harbor" procedure for making difficult compensation decisions.[18]

Although the IRS may still revoke an organization's tax-exempt status for violating the inurement proscription – regardless of whether it imposes the 4958 excise tax – the legislative history suggests that, in practice, the excise taxes often will be the sole sanction imposed when the excess benefit is not sufficiently severe to raise doubts about the organization's identity as a charitable organization.[19] Nonetheless, the preamble to the final intermediate sanctions regulations explicitly state that the IRS may pursue *both* intermediate sanctions penalties and loss of tax exemption in instances where private inurement is found.[20]

### A. The Penalty Taxes

If a disqualified person engages in an excess benefit transaction with a tax-exempt organization (for the purposes of this paper, this means the receipt of unreasonable compensation), both the disqualified person and any organization manager who knowingly participates in the transaction are liable for excise taxes.[21] The exempt organization itself is not subject to the penalty tax.[22] Penalty taxes are calculated as a percentage of the "excess benefit," which is defined as the amount by which the benefit provided to the disqualified person exceeds the value of the consideration (i.e., services) received by the organization.[23]

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[17] Treas. Reg. § 53.4958-1 (2002) (giving the definitions of organization manager and knowingly).

[18] Treas. Reg. § 53.4958-6 (2002).

[19] WILLIAM ARCHER, TAXPAYER BILL OF RIGHTS 2, H.R. REP. NO.104 -506 at 59 n.15 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1143, 1182 n.15.

[20] Treas. Reg. § 53.4958-8(a) (2002).

[21] I.R.C. § 4958(a)-(b)(2000).

[22] I.R.C. § 4958(a) (2000) (conferring tax only onto disqualified persons and management).

[23] I.R.C. § 4958(c)(1)(a) (2000).

The disqualified person is liable for a tax equal to twenty-five percent of the excess benefit, and then, if the excess benefit is not corrected within the taxable period, for an additional tax of 200%.[24] A penalty tax is also imposed on any organization manager who participates in the transaction knowingly, willfully, and without reasonable cause.[25] The tax is equal to ten percent of the excess benefit, not to exceed $10,000 with respect to any one excess benefit transaction.[26] The organization managers' liability is joint and several, with all organization managers limited by a single $10,000 cap per excess benefit transaction.[27] If an organization manager is also a disqualified person, he or she can be subject to both types of excise taxes.[28]

## B. The Rebuttable Presumption Safe Harbor

The regulations provide a safe harbor that enables the organization to establish a rebuttable presumption that no excess benefit transaction has occurred, i.e., that compensation paid to an officer is reasonable.[29] The IRS may rebut this presumption by providing evidence that the compensation was not reasonable. Failure to meet the rebuttable presumption does not create the inference that a transaction between a disqualified person and an exempt organization is an excess benefit transaction.[30]

Compensation arrangements are presumed to be reasonable if the following three conditions are satisfied:[31]

### *1. Independent Committee:*

The specific compensation arrangement must be approved by the organization's governing body or a group of individuals appointed by the governing body that is made up of disinterested individuals.[32] Members of the board or committee cannot be related to the disqualified person benefiting from the compensation arrangement, be in a subordinate employment relationship to such person, receive compensation subject to the person's approval, have a material financial interest affected by the arrangement, or be involved in approving a recip-

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24 I.R.C. § 4958 (a)-(b) (2000).
25 I.R.C. § 4958 (a)(2) (2000).
26 I.R.C. § 4958 (d)(2) (2000).
27 I.R.C. § 4958 (d)(1) (2000).
28 Treas. Reg. §53.4958-1(a) (2002).
29 Treas. Reg. § 53.4958-6 (2002).
30 *Id.*
31 Treas. Reg. § 53.4958-6(a) (2002).
32 Treas. Reg. § 53.4958-6(a)(1) (2002).

rocal arrangement with the person.[33] A board containing a disqualified member will nevertheless qualify as an independent committee if the disqualified member recuses himself from the meeting and is not present during the debate and voting regarding the compensation arrangement.[34] Individuals other than officers, directors or trustees may serve on the committee, but they will then be treated as organization managers for purposes of the penalty tax on managers.[35] The transaction cannot be approved by a committee if either the organization's governing document or state law requires that the committee's decision be ratified by the full governing body in order to become effective.[36]

*2. Reliance on Appropriate Data:*

The board or committee must base its decision on appropriate data, which includes compensation levels paid by similarly situated organizations (whether taxable or tax-exempt) for comparable positions, independent compensation surveys compiled by independent firms, and actual written offers from other institutions competing for the disqualified person's services.[37] Organizations with annual gross receipts of less than one million dollars need only obtain compensation data from five comparable organizations in similar communities, for similar services.[38]

*3. Documentation:*

The board or committee must document the basis for its decision in minutes or other records by the later of the next meeting of the board or committee or sixty days after the meeting at which the compensation decision was made.[39] The records must indicate the terms of the transaction, the date of approval, the members present and who voted in favor of the transaction, the source and substance of the data relied upon, and the actions taken by persons excluded because of their conflict of interest.[40]

It is hard to quarrel with the foregoing procedure for establishing a rebuttable presumption of reasonableness. It is simple and logical. While some interpretive and procedural issues can arise when seeking

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[33] Treas. Reg. § 53.4958-6(c)(1)(iii) (2002).
[34] Treas. Reg. § 53.4958-6(c)(1)(ii) (2002).
[35] Treas. Reg. § 53.4958-6(c)(1)(i) (2002).
[36] Treas. Reg. § 53.4958-6(c)(1)(i)(B) (2002).
[37] Treas. Reg. § 53.4958-6(c)(2) (2002).
[38] Treas. Reg. § 53.4958-6(a)(2)(ii) (2002).
[39] Treas. Reg. § 53.4958-6(c)(3)(ii) (2002).
[40] Treas. Reg. § 53.4958-6(c)(3)(i) (2002).

to follow the three steps, the basic procedure comports so well with exempt organization "best practices" that it is likely to become a virtual requirement when establishing the compensation package for key individuals at large nonprofit organizations, including those in the health care sector.[41]

## III. Sarbanes-Oxley and its Progeny

Although not directly applicable to nonprofit organizations, the enactment of the Sarbanes-Oxley legislation has created a different tenor at nonprofit organizations. Due in part to board members' experience with Sarbanes-Oxley in the private sector, boards of trustees have become increasingly active in seeking to fulfill their fiduciary obligations in a manner that can be objectively established, in particular with respect to compensation setting. Several states, including New York and Massachusetts, are considering the enactment of legislation that will apply to nonprofit organizations rules similar to those contained in the Sarbanes-Oxley legislation, and California has recently enacted such legislation.[42]

## IV. Issues Unique to Health Care Executives

Most of this paper addresses issues that apply equally to health care executives and to executives of nonprofit organizations in general. But several factors apply uniquely to the health care industry and should be kept in mind when analyzing reasonable compensation in the nonprofit health care sector.

*Competition for talent with the for-profit sector.* First and foremost, there exists in the health care industry a vigorous competition for talent between for-profit and not-for-profit health care providers. A CEO of a nonprofit hospital could easily make the crossover to a for-profit hospital and vice versa. While the intermediate sanctions rules clearly state that compensation levels may be set with reference to both the for-profit and nonprofit sectors, the reference to comparable employees in the for-profit sector is often something of an abstract proposition. Who, precisely, performs a role in the for-profit sector comparable to that of the president of a university or charitable foundation? Yet in the health care industry, while important differences

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[41] In fact, a form of such review has recently become legislatively required in California as part of the Nonprofit Integrity Act of 2004 with respect to the chief executive officer and chief financial officer of all charities subject to the jurisdiction of the California Attorney General. S.B. 1262, 2003-2004 Leg., Reg. Sess. (Ca. 2004).

[42] The Nonprofit Integrity Act, Ca. S.B. 1262.

exist, it is far easier to identify comparable positions in for-profit hospitals. To the extent that large for-profit hospitals tend to compensate their executives well, not only through direct salary but also through stock options, deferred compensation, and retirement programs, nonprofit hospitals are required to offer total compensation packages of at least somewhat comparable value in order to attract and retain the most talented executives.

*Compensation level of doctors in general.* A second factor that helps explain relatively high executive compensation levels in the health care industry is that doctors working for or in conjunction with health care organizations themselves tend to be fairly highly compensated compared to, for example, a typical college professor, artist or grantmaker who make up the bulk of most nonprofit organizations' skilled employees. There is much less resistance, either internally or from the public, if an executive of a nonprofit organization is paid at a level reasonably commensurate with the salary paid to the skilled individuals whom he or she manages on a daily basis.

*Commercial revenue as a gauge of success.* Third, hospitals tend to be more "commercial" than most nonprofit organizations, relying on operating revenues for a larger portion of their budget than many other nonprofit organizations. This makes it easier for an executive to point to revenues of the organization in arguing that he or she should be paid at a level commensurate with an executive at a private company with comparable revenues.

*No stock options.* Fourth, the fact that nonprofit executives cannot be compensated with stock options available in the for-profit health care sector also tends to inflate current salaries because current cash would need to make up for the absence of potential growth in equity. Recent attempts by nonprofit organizations to create phantom stock-option plans for nonprofit executives (albeit with the options being for a pool of publicly-traded securities, not for equity in the exempt organization itself) were firmly squelched by the IRS.[43]

*Volatility.* Fifth, the high degree of volatility in the health care industry clearly tends to push compensation levels higher. An executive who sees his or her job position as perilous, and who faces termination for any number of reasons outside the executive's control, will presumably push much harder for "top dollar" when negotiating an employment agreement.[44]

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[43] I.R.C. § 457 (2000).

[44] Treas. Reg. § 1.457-11(d) (2002). *See also* Anup Malani & Albert Choi, *Are Non-Profit Firms Simply For-Profits in Disguise? Evidence from Executive Compensation in the Nursing Home Industry*, Sept. 26, 2004, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=617362. Malani and Choi argue

## THE ROLE OF PRIVATE STAKEHOLDERS IN SETTING COMPENSATION

### Boards of Trustees

Boards of trustees must be diligent in carrying out their fiduciary obligation to analyze compensation packages carefully and independently. While this statement seems obvious, far too many boards of trustees are less than diligent in carrying out this basic function. A reasonable compensation-setting approach is established by the rebuttable presumption "safe harbor" under the intermediate sanctions rules described above,[45] and the board should seek to follow these rules at a minimum. In particular, the board should check for (and address) conflicts of interest, it should review the skills and job demands of the officer and determine how much comparable individuals earn, and it should keep a record if its deliberations.

While there is little doubt that the board of trustees (or its designated committee) should control the CEO's compensation, it is less clear that it should be principally responsible for determining compensation levels of other employees, even if they constitute disqualified persons under § 4958. While the board should retain the authority to be the final arbiter of compensation for key individuals, per the intermediate sanctions rules, it should not exercise this authority in a manner that undercuts the CEO of the organization.

Stephen Sample argues in *In Your Hands a Sacred Trust* that the board of trustees must be careful to not unnecessarily interject itself into personnel issues at a university, observing that the employee in question would come to view him or herself as working for the board, not the president, in that case.[46] Sample supports giving the president of a university a high level of executive authority, with a concomitant level of responsibility.[47] He recounts, somewhat wistfully perhaps, the story of a 19th century college trustee who suggested that the ideal agenda for a board meeting would be as follows:

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that because nonprofits are penalized in various ways for using financial performance incentives, they must rely on turnover to encourage executives to maximize profits (i.e. "we're sorry that we can't give you stock options or a profit-based bonus, but we'll fire you if you don't perform well."). As a result of this volatility, base compensation levels need to be higher in the for-profit sector. The Malani and Choi article also contains a helpful list of references to recent academic articles regarding executive compensation in the nonprofit sector. *Id.* at 29.

[45] Treas. Reg. § 53.4958-6 (2002).

[46] Stephen Sample, *In Your Hands a Sacred Trust*, TRUSTEESHIP, Nov.-Dec. 2003, at 15, 17.

[47] *See id.* at 16.

> "The meeting should open with a prayer, and after approval of the minutes of the earlier meeting, one of the trustees should immediately move to dismiss the president. If the motion fails, the meeting should adjourn!"[48]

Sample raises an important issue. Should the role of the board of trustees in setting the CEO's compensation be treated as fundamentally different from its role in reviewing the compensation levels of other key officers? In the former case, the board must take a leadership role in negotiating an employment agreement, dealing directly with compensation consultants and other legal or accounting advisors. But in the latter case, it may be appropriate for the board to be deferential to the recommended compensation levels proposed by the CEO. While the board must clearly satisfy itself that the compensation levels are reasonable, it should work cooperatively with the president to address any concerns or questions board members may have. If the board has a fundamental disagreement with the compensation policy of the president, this disagreement should factor importantly in its decision whether to retain the president, but should not be used as an excuse to undercut the CEO's authority or to begin micromanaging the affairs of the organization.

Potential Donors

Potential donors should evaluate the wide array of publicly-available information in order to understand the levels of compensation being paid as well as other expenses of a charitable organization; these expenses should be compared to the goals, complexity and success of the organization. Federal, state and local governments can also act very much like a private donors in this regard. Governmental funding agencies have the ability to pick and choose among recipients of governmental grants based on a host of factors, including executive compensation. From a free market perspective, it is more efficient for governmental "control" over compensation levels in the charitable sectors to be exercised by giving or withholding funds, as opposed to the IRS or a state attorney general trying to successfully litigate its view that a particular executive was overcompensated or that the organization is not managed efficiently. Like the public, the government can speak with its money.

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[48] *Id.* at 15.

Patients

Patients, and their advocates, will likely be less concerned with compensation levels than they will be concerned with *results*; an organization that consistently under-compensates its key employees may fail attract the best talent and quality may suffer. ("May" and not "will" is used in the preceding sentence because the nonprofit sector is populated by many highly-talented individuals who effectively make a charitable contribution of their time and talent and willingly accept under-compensation in order to serve the charitable mission of the organization. While admirable, such selflessness is not legally required and probably cannot be expected across the board.) Of late, some patients have exercised another kind of clout by participating in so-called "Scruggs lawsuits"[49] brought against tax exempt hospitals challenging billing practices for the uninsured; discovery requests in these cases have explored compensation-setting processes at the defendant hospitals in an attempt to demonstrate that the hospital has not been operated in an exclusively charitable manner.

## THE ROLE OF IRS AUDIT ACTIVITY

Donors (including governmental grant makers) and patients of nonprofit health care organizations perform a market-based role in regulating these organizations – if they are not happy with what they see they take their money elsewhere. While this kind of natural regulation is desirable, the IRS obviously has an important and continuing role to play. The IRS has recently announced its intention to perform widespread audits of exempt organizations with a particular focus on compensation levels and information reporting.[50] This is an important initiative by the IRS and one that could have significant repercussions throughout the nonprofit world. Because these audits will constitute the first significant test of the effect of the intermediate sanctions legislation of 1996, the IRS, exempt organizations, and their advisors will be highly interested in the results.

But what, exactly, should be the goal of these audits and how will their success be measured? As with so many issues involving tax-exempt organizations, success will not be measured in revenues

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[49] *44 Class Action Lawsuits in 23 States Filed to Date by Uninsured Patient Plaintiffs Against Nonprofit Hospitals*, PR NEWSWIRE, Aug. 13, 2004, *at* http://news.findlaw.com/prnewswire/20040813/13aug2004165413.html.

[50] INTERNAL REVENUE SERVICE, IRS INITIATIVE WILL SCRUTINIZE EO COMPENSATION PRACTICES, *at* http://www.irs.gov/newsroom/article/0,,id=128328,00.html (Aug. 10, 2004).

raised.[51] Rather, the success of these audits should be measured by the following criteria. Does the IRS deal fairly and effectively with those organizations being audited – imposing penalties where appropriate and requiring improved procedural safeguards where the process has been flawed? Do the audits enable the IRS to gather helpful data about nonprofit compliance that will enable the IRS to (a) better educate the exempt organization community, (b) improve the Form 990 so as to best report compensation and benefits, and (c) enable the IRS to conduct further audits in a targeted manner? Finally, and most importantly, do the audits results in more complete and more reliable compensation data being made publicly available so that the stakeholders described above can better serve their market-based role in regulating nonprofits?

When the IRS examines the compensation paid to a nonprofit health care executive there are four possible results, as follows:

- The executive is paid a reasonable amount and appropriate procedures were followed in setting, and reporting, compensation.
- The executive is paid a reasonable amount, but appropriate compensation procedures were not followed.
- The executive is arguably paid too much, but appropriate compensation procedures were followed.

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[51] An interesting aspect of "excessive compensation" audits is that IRS agents performing such audits are being asked, in effect, to seek to minimize federal tax revenues. IRS regulation of tax-exempt organizations has always been a curious state of affairs – the IRS essentially filling a void left by the inaction of most state charity regulators. But, in most cases, the IRS could at least be seen as seeking to protect federal revenues. If a charitable organization is stripped of its tax-exempt status by the IRS, additional federal revenues may accrue because of decreased charitable contributions to that organization and because of tax on operating and investment income of the charity if the revocation is retroactive. Audits of unrelated business activities can also generate additional federal revenues, as could a typical employment tax or retirement plan audit. Yet the payment of excessive compensation works in the opposite direction. Every $100 of excess compensation paid to an already highly compensated executive gives the federal government a windfall of approximately $35 in income taxes and three dollars in employment taxes. It is unlikely that the IRS will successfully offset these revenue losses by the imposition of either the 25% or 200% penalties under § 4958 (a)-(b) or the 10% managers' penalty under § 4958 (a)(2). Far more likely would be an agreement by the executive to simply return some of the excess compensation to the organization, for which he or she would claim an offsetting tax deduction, thereby reducing federal tax revenues. While the foregoing situation should not be seen as a call for IRS inaction in order to help balance the federal budget, it highlights the fact that the IRS Exempt Organizations Division is being asked to stray even further from its traditional role of safeguarding federal revenues and to squarely shoulder the job of charitable overseer, a job more appropriately handled by state attorneys general.

- The executive is arguably paid too much and appropriate compensation procedures were not followed.

In the first situation all parties go away happy. In the second situation (reasonable pay, inappropriate process), the well-meaning but perhaps ill-advised nonprofit may face an uncomfortable conversation with the IRS about "automatic excess benefit transactions" (i.e. items of compensation not treated as such)[52] or about correct information reporting. Many nonprofits will fall in this category and it is imperative that the IRS handle these cases in an appropriate manner – firm but understanding. Playing "Gotcha!" with relatively minor items of compensation such as automobile use, cell phones, discounted goods and services and the like will not be especially helpful and the intermediate sanctions penalties should be applied sparingly in these cases.

In the third situation (high pay, appropriate process), the IRS will have a difficult time making intermediate sanctions penalties stick. A committee that has carefully ensured that no member has a conflict of interest, has analyzed data as to salaries paid to individuals of comparable skill and responsibility in the nonprofit and commercial sectors, and has recorded its deliberations and the rationale for its conclusions will have built a solid case that the compensation level is reasonable and will benefit from a presumption to this effect. While there will likely be extreme cases that prove to be the exception, it will be very difficult for the IRS to successfully argue that an executive who is paid, for example, one million dollars was really only worth $500,000, notwithstanding the deliberations of the board or compensation committee.

Finally, organizations that have paid "top dollar" for an executive and have not followed the recommended compensation-setting procedures will find themselves in a compromised position with the IRS. As is often the case with nonprofit organizations that must deal with somewhat vague restrictions ("substantial" lobbying, "unrelated" business, and "excess" compensation), careful procedural safeguards and documentation are key. If the IRS hopes to have an impact on compensation-setting in the nonprofit sector, it should measure its success in the adoption by charities of procedural safeguards, not a win-loss record when battling over the definition of reasonable compensation.

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[52] Fred Stokeld, *Agents Shouldn't Get Carried Away With Minor 4958 Violations, IRS Official Says*, PLANNED GIVING DESIGN CENTER, May 03, 2004, *at* http://www.pgdc.com/usa/item/?itemID=207217.

## CONCLUSION

A market-based approach to compensation setting in the nonprofit health care sector is far preferable to direct governmental regulation of salaries. The IRS is simply not in a position to start determining appropriate compensation levels for executives in a complex, fragmented, ever-changing industry. While some might argue that intermediate sanctions have failed if the IRS cannot use them to directly exert a downward pressure on salaries, this is not the case. Intermediate sanctions are most beneficial in strongly encouraging a compensation-setting *process*, not in actually serving to depress salaries across the nonprofit spectrum.[53] The current IRS audits of nonprofit compensation levels will serve the important role of pushing exempt organizations towards greater accuracy and uniformity in reporting salary levels on the IRS Form 990. As noted above, these audits will probably reveal both sloppiness in reporting of compensation by many organizations as well as highlight ambiguities and omissions in the Form 990 itself. The combination of a serious enforcement effort with respect to compensation reporting, plus an improved Form 990 and instructions, will greatly facilitate the effectiveness of third-party oversight of charitable organizations, such as that exercised by donors and patients.

[53] In fact, intermediate sanctions may have had an *inflationary* influence on salaries, providing a protective umbrella beneath which salaries can be raised with relative impunity. By providing an easy-to-apply safe harbor for creating the rebuttable presumption, together with the natural tendency to assume than an organization's executive is "above average," (the "Lake Wobegon Effect") salaries will tend to grow. In addition, even for organizations not intent on pushing salaries to the maximum, the ready availability of comparability data, combined with the appropriate use of the rebuttable presumption of reasonableness, will likely cause organizations with below-average compensation to increase compensation levels towards the mean.