TAX EXEMPT ORGANIZATIONS COMPENSATION AUDITS: 403(b) AND 457(b) AND (f)

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For years, tax-exempt hospitals and other tax-exempt institutions have been quietly performing their civic and charitable missions below the IRS radar. There are nearly one million charitable organizations exempt under Section 501(c)(3) of the Internal Revenue Code of 1986 (the "Code"), and historically for the past several years the IRS examination rate for these organizations has been below one percent (1%). This is changing, in a big way. Large tax-exempt hospitals will be particularly impacted as the IRS makes up for lost time.

This outline will first review the new IRS audit programs and related initiatives. It will then describe the IRS arsenal of additional taxes and penalties that the IRS can impose when problems are discovered. Paramount among these are the "intermediate sanction" excise taxes imposed personally on the directors and officers of an exempt organization under Section 4948 of the Code. Finally, this outline will summarize steps that can be taken to prepare for, defend against, and recover from, the IRS audit.

IRS Audit Initiatives

The Tax Exempt Compensation Enforcement Project. In August 2004, the IRS acknowledged a new enforcement effort, called the "Tax Exempt Compensation Enforcement Project" ("TECEP"), to identify and halt "abuses" by tax-exempt organizations that pay "excessive" compensation and benefits to their officers and other insiders. The initial step is an audit of nearly 2,000 charities and foundations aimed at their executive compensation practices and procedures. TECEP actually began in July, 2004 and is expected to continue into 2005, with three primary goals:

- to address the compensation of certain persons or instances of questionable compensation practices;
- to increase awareness of tax issues as tax-exempt organizations design their executive compensation programs in the future; and
- to learn more about the practices that tax-exempt organizations are following as they set compensation and report it to the IRS on Form 990.

While TECEP is not by its terms specifically aimed at hospitals within the tax-exempt sector, the relative size and economic significance of tax-exempt hospitals will predictably result in a disproportionately large portion of IRS audit activity focusing on tax-exempt hospitals. Further, while the vast majority of tax-exempt hospitals do not engage in intentionally abusive practices designed to siphon assets off to founders, officers or key board members, unknowing or unintentional failures nonetheless are the target of IRS audits. All tax-exempt hospitals are particularly vulnerable in the executive compensation area because they must compete for talent -- both medical and administrative -- with for-profit hospitals and health service organizations, and must pay compensation and provide benefits accordingly. Tax-exempt hospitals are therefore uniquely exposed to allegations of "excessive" compensation even though

they follow compensation practice that are normal and widely accepted within their sector. They are a fertile ground for IRS audits.

TECEP is not an end in itself. The IRS can be expected to use the information on specific areas of excessive compensation noncompliance to target those issues for future audit. IRS spokespersons have recently indicated this process may occur by 2006.

TECEP joins other IRS initiatives aimed at tax-exempt organizations that are already underway:

Audit Program Targeting Tax-Exempt-Employer Benefit Plans. Even before TECEP, the IRS launched an audit initiative for employer-sponsored retirement plans, with special emphasis on two types of plans that are maintained only by tax-exempt organizations (or governments): tax sheltered annuity programs established under Section 403(b) of the Code, and deferred compensation plans under Internal Revenue Code Section 457(b) (eligible plans) and Section 457(f) (ineligible plans) of the Code.

IRS spokespersons have stated that the IRS will be taking an especially hard look at large plans -- those with 2,500 or more participants, because those plans control between 60 and 70 percent of all retirement plan assets. Targeted audits of these plans, with attendant publicity, are expected to have a disproportionately large influence on compliance by all tax exempt entities.

Considering that 403(b) and 457 arrangements can be offered only by tax-exempt organizations and governments, taking into account the emphasis on large plans, and subtracting governmental plans (harder for the IRS to effectively audit because of political and federalism concerns), tax-exempt hospitals are again left as the unstated but obvious target for this audit initiative. As with executive compensation, hospitals may not view their 403(b) and 457 plans as matters of concern where they have purchased the product from reputable financial institutions and their employees are seemingly happy. However, the complex and arcane tax rules for these arrangements make it easy for the IRS to find deficiencies. Specific issues investigated under the 403(b)/457 audit program include:

- Violation of the universal availability requirement for elective Section 403(b) deferrals;
- Excess employer contributions and employee elective deferrals;
- Annuity contracts and custodial accounts violating the nontransferability, anti-assignment, direct rollover, minimum distribution, and salary deferral limit requirements;
- Failure to satisfy minimum distribution requirements in operation;
- Failure to stop salary deferrals after a deemed “hardship” distribution;
- Conflicts between plan language and operation;

- Improper use of the "catch-up" election for Section 457(b) plans; and

- Failure to include vested contributions in income under Section 457(f) plans.

Other Audit Initiatives. The IRS audit initiatives for TECEP, Section 403(b) plans and Section 457 plans specifically target the compensation and benefit programs of tax-exempt organizations; but hospitals are also jeopardized by IRS audits on executive compensation issues they share with the for-profit sector. The IRS has increased its audit activity for compensation programs generally. Last year, the IRS announced that it was undertaking the audit of selected executive compensation and benefit issues, including, among others:

- *The taxation of non-qualified deferred compensation.* Tax-exempt organizations themselves might not be concerned with the deductibility of non-qualified deferred compensation (though employment taxes may remain an issue), but they may have withholding liability, and their executives will be vitally concerned with personal tax deficiencies arising out of mistakes in the design or implementation of these programs. These concerns will only be exacerbated by the new deferred compensation legislation recently enacted and going into effect January 1, 2005 as Section 409A of the Code.

- *Split-dollar life insurance*. The IRS may separately commence examinations of split-dollar life insurance arrangements. Issues include not only compliance of ongoing plans with the recent regulations, but whether ostensibly grandfathered plans are actually entitled to the pre-regulation continued favorable tax treatment claimed for them. Again, personal tax deficiencies for executives (as well as employment tax liability for the hospital) are the likely result of defects.

- *Fringe benefits*. The IRS is looking for areas of noncompliance with respect to fringe benefits, including spousal travel, travel on company aircraft, and excessive consulting fees to former executives.

Naturally, an audit initially raising executive compensation, 403(b) or 457 plan issues can easily metastasize into other areas. Executive compensation issues can easily lead to intermediate sanction excise tax penalties even if the hospital is not initially selected for audit in that area. Hardy perennial issues like employment taxes are of permanent interest to the IRS, and most audit adjustments to compensation will also have employment tax consequences. If an IRS agent discovers a potential issue under non-tax law, such as the Stark Law, the Medicare/Medicaid anti-kickback statute, or the Employee Retirement Income Security Act of 1974 ("ERISA"), the agent can refer the issue to the appropriate enforcement agency.

Agent Training to Enforce Intermediate Sanctions. The IRS is supporting TECEP (and other initiatives) with enhanced training for agents. In late 2003, the IRS published a continuing professional education article (the "CPE Article") for its agents on its website to facilitate agents' enforcement of the intermediate sanctions excise taxes on "disqualified persons" and "organization managers" of tax-exempt organizations.

The CPE Article gives agents specific guidance on when an economic benefit from a tax-exempt organization to a "disqualified person" may be treated as an automatic excess transaction subject to the intermediate sanctions excise tax. The CPE Article also addresses the substantiation requirements to determine whether a benefit should be treated as compensation, and how to determine whether a benefit is reasonable compensation. These issues are discussed as part of the IRS arsenal described below.

Together these initiatives demonstrate that the IRS is very serious about excessive compensation paid by tax-exempt organizations to their executives, and that it is prepared to assess substantial penalties for non-compliance, including excise taxes and potentially, the revocation of the organization's tax-exempt status. The Commissioner of Internal Revenue has recently warned charities that they are facing "the gathering storm," and has advised the Senate Finance Committee that abuse is increasingly present in the tax-exempt sector, with the high levels of compensation for exempt organization executives being one of the top compliance problems.

The IRS could hardly be more forthright about its intentions. Tax-exempt organizations have no excuse not to brace for the coming onslaught.

The IRS Arsenal

The IRS has a panoply of sanctions to remedy or punish mistakes in or violations of the tax law by tax-exempt or other entities. These range from interest on tax deficiencies to prison sentences for criminal tax fraud. Any of these might apply to tax-exempt hospitals or their executives in appropriate cases. The discussion here will focus on four areas unique to tax-exempt organizations -- the intermediate sanction excise taxes for public charities; the penalties for errors and omissions on the organization's Form 990 information return; the revocation of exemption; and the consequences of defects in 403(b) and 457 plans.

Excise Taxes on Hospital Directors and Officers. Section 4958 of the Code imposes so-called "intermediate sanction" excise taxes on "disqualified persons" and "organization managers" of tax-exempt public charities (and 501(c)(4) organizations) whenever an impermissible "excess benefit transaction" occurs with the organization. An excess benefit transaction may include unreasonable compensation paid to a disqualified person, or even reasonable compensation not contemporaneously designated as such.[*]

There are two potential excise taxes: a tax on the disqualified person(s) who benefited from the transaction, and a tax on the organization manager(s) who knowingly participated in the transaction.

The excise tax penalty on disqualified persons involved in the excess benefit transaction is levied in two tiers, as follows:

[*] Excess benefit transactions and disqualified persons are further described in the Appendix to this paper.

- All involved disqualified persons are jointly and severally liable for a first tier tax of 25% of the amount of the excess benefit.

- If the excess benefit transactions is not corrected before the earlier of the date the notice of deficiency was mailed or an initial tax was assessed, the disqualified person(s) are liable for a second tier tax of 200% of the excess benefit received.

An excess benefit transaction is corrected by undoing the effects of the excess benefit and taking any additional measures necessary to place the tax-exempt organization involved in the excess benefit transaction in a financial position not worse than in which it would be if the disqualified person were dealing under the highest fiduciary standards.

The excise tax penalty on each organization manager involved in the excess benefit transaction is 10% of the excess benefit paid (up to $10,000 in aggregate from all managers per excess benefit transaction), unless the manager's participation in the transaction is not willful and was due to reasonable cause. Organization managers include any officer, director or trustee of an exempt organization or any person having powers or authority similar to such officers, directors or trustees (regardless of title).

Although the statute requires "knowing participation" for an organization manager to be liable, the regulations define "participation" to include silence or inaction on the part of an organization manager where the manager is under a duty to speak or act (as well as any affirmative action by such manager). The regulations do not indicate what law supplies the duty to speak or act, but the entity governance standards stated in (or drawn from) the organization's governing state law provide at least a minimum standard that must be satisfied.

It must be stressed that these excise taxes are not imposed on the exempt organization, but must be paid personally by the disqualified person(s) and organization manager(s) involved in the transaction. The exempt organization itself is not liable for these excise taxes, and generally may not reimburse the disqualified persons or organization managers for excise taxes imposed upon them, because any such payment to one of those persons, even a payment designated and treated as compensation, is itself another potential excess benefit transaction.

While the excise taxes are the main penalty for an excess benefit transaction, a competent IRS agent can easily spin the transaction into a ramifying web of additional deficiencies, violations and penalties. Indeed, the CPE Article noted above tells agents how to take such steps. Consider a simple "automatic" excess benefit transaction arising from a benefit to a hospital officer not contemporaneously reported as compensation. The amount is income to the officer, who is personally liable for a tax deficiency, interest and perhaps penalties, respecting his or her own taxes. The amount is "wages" so the hospital is liable for the appropriate employment taxes (and interest and perhaps penalties for failure to timely deposit), and for failure to withhold the income tax (at least if the tax is not paid by the officer).

Further, an excess benefit transaction must be reported on Form 4720. So, if the form was not timely filed along with a tax payment (i.e., if the transaction is not caught until the IRS audit), the officer is liable for a failure to pay penalty under Section 6651 of the Code (and the

officer or the hospital may have a failure to file penalty as well). If the compensation is not reported on the Form 990 and/or the Form 990 question about excess benefit transactions is answered "no," there can be further penalties (discussed below) on the hospital for failure to file a correct Form 990. And particularly in light of the personal liability aspect of the excise tax, the cost to the hospital in lost time and distraction for its officers and for defense expenses may far outweigh the dollar amount of the aggregate taxes, interest and penalties paid to the IRS.

Revocation of Tax Exemption. The Code provides for "intermediate sanctions," and the IRS encourages agents to apply them. They are called "intermediate" sanctions because the alternative sanction -- and for many years the only sanction available to the IRS -- is revocation of exemption, a drastic remedy that the IRS is reluctant to employ except in the most abusive of cases. However, revocation of exemption for violation of the prohibited inurement mandates of Section 501(c)(3) of the Code is available, and has been used, to remedy or punish abusive compensation paid by ostensibly tax-exempt organizations. Revocation of exemption creates income tax liability for the organization (with interest and perhaps penalties) for open years over which the revocation is effective, and loss by donors of the tax deduction for their contributions. Of more practical significance, revocation of exemption is frequently a death sentence for the organization itself.

Prohibited inurement jeopardizes a hospital's exempt status because tax exemption under Section 501(c)(3) of the Code requires an organization to be operated (as well as be organized) exclusively for exempt purposes. An organization is not operated exclusively for exempt purposes if any part of the net earnings inures in whole or in part to the benefit of the private shareholders or individuals. Prohibited inurement encompasses two related but distinct issues:

- Diverting the net earnings of a Section 501(c)(3) organization such that they inure, in whole or in part, to the benefit of private shareholders or other individuals with an ability to influence the decision-making activities of the exempt organization (collectively, "insiders"); and

- Operating to benefit private rather than public interests.

The first aspect of prohibited inurement essentially prevents insiders from receiving any portion of the exempt organization's net revenues, except for reasonable payment for goods or services. This prohibition is limited to insiders. The statute's proscription suggests strict liability for offenders (with no *de minimis* exceptions). Therefore, if payment to an insider is any amount that is more than "reasonable" (often measured by fair market value), there may be a private inurement issue. Private inurement may arise, for example, from the payment of unreasonably high compensation to controlling employees of the organization, or from compensation mechanisms that provide a controlling employee with, in effect, an interest in the profits of the organization. Likewise, if the exempt organization provides an item or service to an insider for less than a reasonable amount, a private inurement issue may exist. Other private inurement situations include payments to insiders based on net earnings or some transfers of revenue producing property between the organization and an insider.

The other leg of prohibited inurement mandates that an exempt organization's activities may benefit private interests only to the extent such benefits are incidental to the organization's

exempt (public) purposes. Hence, an organization that serves a public interest, but also serves a private interest more than incidentally, will not be entitled to Section 501(c)(3) status. Unlike the private inurement prohibition, the private benefit prohibition applies to all private interests, not merely those of insiders. Analysis under the private benefit "incidental to" standard has both qualitative and quantitative components. Qualitatively, the public benefit must not be one which can be accomplished without necessarily creating a private benefit. Quantitatively, the private benefit must be no greater than necessary to achieve the exempt (public) purposes. In general, a transaction at fair market value will not result in more than incidental private benefit relative to the public benefit.

The newly revised Form 1023, Application for Recognition of Exemption, reinforces the importance of executive compensation standards to tax exemption (and therefore potentially to revocation of exemption). Part V of the revised form asks some 25 specific questions about compensation or other financial arrangements with officers, directors, and trustees. These include questions respecting whether the organization follows six "recommended" compensation practices. Although the form states that observing such practices is not required to obtain an exemption, organizations that answer "no" to any one of those items must supply a narrative description of how they set "reasonable" compensation. A similar set of items inquires about the organization's conflict of interest policy. Although the basic form again states that a conflict of interest policy is not a precondition for tax-exemption, hospitals are specifically asked if they have a conflict of interest policy consistent with the policy conveniently included in the instructions to the form. The types of information now being requested from new tax-exempt organizations suggest likely areas of concentration in audits of existing tax-exempt organizations.

Form 990 Return Penalties. Section 6033 of the Code requires that every exempt organization file an annual return under such forms as are prescribed; and regulations prescribe for that purpose the Form 990 to be completed in the manner stipulated by its instructions. Part V of the current Form 990 requires a listing of officers, directors, trustees, and key employees; and for each of them requires disclosure in column D of the compensation of the individual and the "contributions to employee benefit plans & deferred compensation." Question 89b of the Form specifically asks whether the organization engaged in any Section 4948 excess benefit transaction during the year.

Those instructions are quite imprecise as to many of the forms of benefits (such as unfunded supplemental executive retirement benefits) paid by exempt organizations to their senior executives.[*] Accordingly it is easy for an IRS agent to identify items of compensation that the agent is unable to trace (in the amount the agent deems appropriate) into the Form 990.

[*] Instructions for Part V state that the amount is to include "all forms of deferred compensation and future severance payments (whether or not funded; whether or not vested; and whether or not the deferred compensation plan is a qualified plan);" state that the applicable plans include "medical, dental life insurance, severance, severance pay, disability, etc." arrangements; and adds that "salaries and other compensation earned during the period covered by the return, but not yet paid by the date the organization files its return," are also to be shown. The instructions say that "reasonable estimates may be used if precise cost figures are not readily available."

If the agent finds an excess benefit transaction, the organization's failure to have reported it in the Form 990 (and Form 4720) automatically creates a reporting omission.

For a tax-exempt organization with gross receipts exceeding $1 million per year, the applicable penalty under Section 6652(c)(1) for "failure to include any of the information required to be shown on a return filed under Section 6033 or Section 6102(a)(6) or to show the correct information" is $100 per day, up to a maximum of $50,000 per return, for "each day during which such failure continues."

The penalty is subject to abatement "with respect to any failure if it is shown that such failure is due to reasonable cause." Generally, the reasonable cause exception to the penalty is determined on a case-by-case basis taking into account all relevant facts and circumstances. These include the factors that prevented the organization from complying with the law; whether the organization exercised ordinary business care and prudence; and whether steps have been taken to prevent the same situation from occurring in the future.

The three-year statute of limitations in Section 6501(c) should apply to any penalty under Section 6652. However, the statute of limitations does not begin to run when material information is omitted from a Form 990 so that the IRS's ability to perform its duties is seriously hindered, since in that situation the organization is considered to have failed to file any return at all. Prior to 1987, Section 6652 imposed a penalty only for failure to file a Form 990, not for filing an incorrect return. Accordingly, the IRS developed a very broad view, which to some extent continues today, of when failure to include information was tantamount to failure to file a return. This once mainly permitted the IRS to collect penalties it could not otherwise assert. Now it means mainly that the statute of limitations may never have begun to run.

Benefit Plan Penalties. Qualified employee benefit plans like 401(k) plans must comply both in form and operation with detailed requirements of Code, a detailed review of which is beyond the scope of this outline. The IRS has historically taken the position (with court decisions in its favor) that strict compliance is required and that any failure in form or operation causes the plan to become disqualified, subject to mitigation under the Employee Plans Compliance Resolution System ("EPCRS") discussed below among the defenses to an audit. Disqualification may apply retroactively to all open-tax years since the failure occurred.

Upon disqualification, the trust becomes taxable (responsible for tax deficiencies, interest and perhaps penalties). Such tax liability normally drains off a substantial part of the assets of the plan, raising the specter of employer (or director or officer) fiduciary liability under ERISA for permitting such disqualification to occur.

Participants also incur taxable income equal to their vested interest in employer contributions allocated to their accounts (or otherwise increasing their vested interest in the trust,

for a defined benefit plan) for the years of disqualification, with two exceptions relating to the coverage requirements of Section 410(b) and Section 401(a)(26) of the Code.*

- If one of the reasons the plan is disqualified is a violation of the coverage requirements, highly-compensated employees must take into income their entire vested interest in the plan (including their interest accumulated in years when the plan was qualified).

- If the only reason the plan is disqualified is a violation of the coverage requirements, participants who are (and were) not highly-compensated employees do not incur income.

A taxable employer (including a taxable subsidiary of an exempt hospital) will also lose its deduction for contributions except to the extent they are vested allocations to individual accounts in the plan.

For tax-sheltered annuities maintained under Section 403(b) or deferred compensation plans under Section 457, the situation is more complicated, because there is no concept of "disqualification" of the plan as such. Instead, the benefit obtained from the plan is exclusion of certain amounts from employees' income; and the consequence of a failure is the inclusion of such amount (with interest for the employees and in some circumstances excise taxes and employment tax consequences for the employer). However, whether this extends to all participants, or only the participants affected by the failure, depends on the nature of the failure.

For this purpose, failures under a 403(b) plan are divided into "plan failures," "annuity contract failures" and "transactional failures." Plan failures affect the plan as a whole and result in income inclusion with respect to all annuity contracts (or custodial accounts) purchased under the plan (together with tax withholding employment taxes, and excise taxes in certain cases). Plan failures include discrimination with respect to employer or salary reduction contributions, failure to satisfy the minimum participation rules and inadequate coverage. For discrimination respecting matching contributions, an excise tax under Section 4979 may also apply.

"Annuity contract failures" generally result in income inclusion (and related consequences) only with respect to the particular annuity contract involved. Annuity contract failures include failure of a custodial account to invest exclusively in regulated investment company stock, impermissible distributions, and uncorrected excess deferrals. The excess deferrals are included in income both in the year contributed and in the year distributed.

Finally, "transaction failures" result in income inclusion only with respect to a portion of the contributions made to purchase the annuity contract. Transaction failures include contributions in excess of the exclusion allowance or the Section 415 limit, and lack of a legally binding salary reduction agreement.

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* Sections 410(b) and 401(a)(26) require generally that plan coverage not discriminate in favor of highly-compensated employees, and that defined benefit plans cover at least 50 employees or 40% of all employees in the employer group.

Defending Against the Audit

Rebuttable Presumption for Reasonable Compensation. The main defense against intermediate sanctions is the rebuttable presumption that compensation is reasonable if the procedures for making the compensation decision satisfy the standards prescribed by the regulation. This is frequently referred to as a "safe harbor," but actually it only shifts the burden of proof to establish that compensation for benefits from a property transaction is reasonable. If presumption is satisfied, then it is up to the IRS to show that the arrangement is in fact unreasonable. If the requirements for establishing entitlement to the presumption are not satisfied, the organization may still be able to show that compensation was reasonable, but it will have the burden of proof and may face a lengthy fight with the IRS while it tries to justify the questioned compensation. In practice, the rebuttable presumption sets the minimum standard that tax-exempt organizations should satisfy for approving compensation arrangements.

Under the IRS's regulations, an exempt organization has the benefit of the rebuttable presumption if the board approving the compensation

- was composed entirely of individuals who are independent and do not have a conflict of interest,
- obtained and made its determination based on proper comparability of compensation data, and
- adequately documented the basis for its compensation decision concurrently with such determination.

Each of these criteria merits a closer look.

No Conflict of Interest. Generally, under the IRS regulations, a board member (or trustee) will not be considered to have a conflict of interest regarding the approval of the compensation arrangement or other transaction if he or she

- is not the disqualified person (or a family member of such person) participating in or economically benefiting from the compensation arrangement or property transfer,
- is not in an employment relationship subject to the direction or control of a disqualified person,
- is not receiving compensation or other payments subject to the approval of a disqualified person,
- has no material financial interest affected by the compensation arrangement (or property transfer), and
- does not approve a transaction providing economic benefits to any disqualified person participating in a compensation arrangement (or receiving

a property transfer) who, in turn, has (or will) approve a transaction providing economic benefits to the board member.

To the extent that applicable state law permits the board to delegate its authority (for example, to determine compensation arrangements), those acting with delegated authority likewise must ensure that they satisfy the rebuttable presumption requirements, since they will also be treated as organization managers subject to the excise tax if the compensation awarded is found to be excessive.

Appropriate Comparability Data. The second requirement to satisfy the rebuttable presumption is that the board members or trustees must obtain and rely upon appropriate comparability data prior to approving the compensation arrangement (or property transfer). Comparability data is considered appropriate when, given the knowledge and expertise of the board members, it offers a sufficient amount of information for them to determine that either the compensation arrangement is reasonable (or the property transfer was made at fair market value). To determine reasonableness (or fair market value), the IRS regulations set forth valuation standards which must be met as part of the board's determination regarding compensation arrangements (or property transfers). Standards for the reasonableness of compensation are drawn from Section 162 of the Code, and the board members must take into account the aggregate amount of all compensation and benefits to an individual. The IRS regulations provide that the reasonableness of compensation should be measured by the amount that would normally be paid for like services in like enterprises under like circumstances, without distinguishing as to whether the "like enterprise" is a for-profit or a tax-exempt organization.

All economic benefits given to a person by the tax-exempt organization in exchange for services need to be considered in examining whether the compensation arrangement is reasonable. The IRS regulations specify that the types of economic benefits that must be considered include:

- all cash and non-cash compensation (e.g., salary, fees, bonuses, severance payments, deferred compensation, as well as pension, profit sharing and stock bonus plan benefits);

- payment of liability insurance premiums (unless excludable as a *de minimis* fringe benefit), as well as payment or reimbursement by the organization for penalties, taxes or the expense of a correction owed under Code Section 4958, expenses not reasonably incurred in connection with a civil proceeding resulting from the person's performance of services for the organization, or expenses resulting from an act or a failure to act to which the person has acted willfully and without reasonable cause; and

- all other compensatory benefits, whether or not included in gross income for tax purposes, including welfare benefits (e.g., medical, life, dental, disability insurance coverage) and fringe benefits (other than those under Code Section 132), expense allowances and reimbursements, and the economic benefit of below-market loans.

Relevant information (for organizations with annual gross receipts of more than $1 million) to consider in determining whether such compensation is reasonable include:

- compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions (such organizations may extend beyond the organization's geographical area);

- the availability of similar services in the geographic area of the organization;

- current compensation surveys compiled by independent firms; and

- actual written offers by similar organizations competing for the services of a particular individual.

The regulations give a specific example of what the IRS expects from a tax-exempt hospital seeking to renew the employment contracts. The example involves the chief executive officer and chief financial officer. In this example, the board commissioned a customized compensation survey from an independent firm that specializes in consulting on issues relating to executive placement and compensation. The survey covered executives with comparable responsibilities at a significant number of tax exempt as well as taxable hospitals. The different variables analyzed in the survey included the size of the hospitals, the nature of services provided, the experience level and level of responsibility of executives, and the composition of the annual compensation arrangements. In addition to the survey results, the board members reviewed a detailed written comparison of the hospital's executives to the executives covered by the survey, and were also given an opportunity to ask questions of the firm that prepared the survey and analysis. This example in the IRS regulations concluded that the survey, as prepared and presented to the board, constitutes appropriate comparability data.

Beyond examining the reasonableness of compensation paid to executives of non-profit organizations, boards must also ensure that any intention to treat benefits provided to executives is <u>contemporaneously</u> acknowledged or treated as compensation. This is necessary to avoid an "automatic" excess benefit transaction as discussed above.

<u>Documentation</u>. The third element of the rebuttable presumption is that the board (or other authorizing body) must adequately document its reliance on the rebuttable presumption, its decision-making process and the basis for such decision, and the members who participated in the decision-making process. Generally, such documentation should be done in the board's or committee's minutes. Specifically, the IRS regulations provide that the record or minutes must document:

- the terms of the transaction that was approved and the date of its approval;

- the members of the board or committee who were present during the debate or discussion of the transaction that was approved and who voted on the proposal;

- the comparability data obtained and relied upon by the authorized body and how the data was obtained; and

- any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the board or committee, but who had a conflict of interest with respect to the transaction.

Further, if the board or committee determines that a particular arrangement warrants compensation that is either higher or lower than the range of comparability data obtained, a record of the board's or committee's determination must be made part of the record.

The IRS regulations again require that the above-described documentation be done contemporaneously with the approval of the transaction. Thus, boards or the committees making these types of decisions should not only make records of their meetings and the factors taken into consideration in their decision-making process, but they should finalize the meeting minutes and other records before the later of (i) the next meeting of the board or committee or (ii) 60 days after the final action(s) of the board or committee is taken. It is also important for corporate governance purposes, as well as to satisfy the rebuttable presumption, that the board or committee members review the minutes and other records to ensure that they are reasonable, accurate and complete.

The requirement for contemporaneous documentation sets the major limit on the benefit of the rebuttable presumption, since it is not possible to retroactively create contemporaneous documentation for prior years. Of course, this should not prevent exempt organizations from reviewing their procedures for determining compensation to ensure that the rebuttable presumption is satisfied for future years. Nor should it prevent organizations from collecting and organizing whatever relevant information exists for prior years so it is available to support the organization's case on the issue for which it must bear the burden of proof.

Review of Form 990 and Consideration of Amended Returns. It is also prudent for exempt organizations to review the adequacy of compensation disclosures on prior Forms 990 for open years. Working papers should be available to show how each item of compensation was valued and how that value was reflected in the Form 990. If this process leads to a conclusion that the original Form 990 was incorrect, the organization should consider filing an amended return.

Generally, there is no legal requirement that an organization file an amended information return, at least where actual tax liability (income and deductions) is not affected and the original return was not fraudulent. The filing of an amended return is also an admission that the original return was erroneous. However, the filing of an amended return will normally cut off the further accrual of penalties (such as the $100/day penalty discussed above) for filing an incorrect original return. Even as to penalty amounts that have already accrued, voluntarily filing an amended return provides a strong argument that penalties for the original return should be abated. The public disclosure requirements for Form 990 may also be a factor. An exempt organization must make its Form 990s publicly available, and that mandate would also extend to an amended return that is intended to be the organization's official information return for tax

purposes. Other considerations will also be relevant to the decision depending on the underlying facts and circumstances.

Review of Plans and the EPCRS Program. For failures in complying with the requirements for qualified plans (like 401(k) plans), and also for most defects in 403(b) plans, the IRS has established an Employee Plans Compliance Resolution System ("EPCRS"). Generally, the EPCRS provides for

- self-correction of certain operational failures (including, in some circumstances, significant operational errors corrected before the plan is audited) with no notice to the IRS and no sanction paid to the IRS,

- correction of other errors with IRS approval through submission of the issue to the IRS, payment of a "compliance fee" depending mainly on the size of the plan, and obtaining a compliance statement,

- correction of errors discovered upon IRS audit, subject to payment of a negotiated sanction that (for 403(b) plans) is a percentage of the income tax that the IRS could otherwise collect as a result of the failure.

The graduated sanction amounts and other features of EPCRS are designed to encourage plan sponsors to self-audit their plans and correct errors before they are discovered upon an IRS audit. Given the IRS audit emphasis on 403(b) plans, tax exempt organizations should take advantage of this opportunity. However, utility of EPCRS is limited in some respects by technical restrictions on the types of plans and errors that qualify for relief and the circumstances in which particular kinds of relief are available. In particular, EPCRS is not open to 457(b) plans; though principles similar to those of EPCRS can be applied in resolving with the IRS issues that such plans may present.

More practically, the costs of correction under EPCRS may be high, since EPCRS requires full correction for all participants for all years (not just open years). Correction must put the affected participant in the same position as if no error had occurred. The EPCRS interpretation of this requirement is very pro-participant. For instance, if individuals were improperly excluded from making elective deferrals under a 403(b) plan, the amount they "would have" deferred must be determined and paid into the plan with interest or earnings; even though their inability to defer means that by definition they have already received the amount in cash. In effect, correction of this kind of failure requires a double payment to the individual.

Avoiding Problems and Minimizing the Risks. The common thread that runs through all exempt organization defenses to the IRS audit arsenal is that it is vital for a hospital to self-audit its executive compensation and related benefit programs before the IRS knocks on the door. The governance and compliance audit of the tax-exempt organization should be designed:

- to ensure proper compliance with appropriate business judgment standards;

- to build a record that bolsters the conclusion that the compensation is reasonable:

- independent compensation committee approves the compensation,
- independent compensation committee's conclusions are supported by independent compensation data, and
- maintenance of contemporaneous board minutes which set forth not only the committee's conclusions but also its actual consideration of the compensation consultant reports or other independent compensation data.

- to ensure that particular compensation arrangements substantively comply with the tax requirements applicable to them:

  - 401(k) or other qualified plans,
  - 403(b) plans,
  - 457 plans,
  - non-qualified deferred compensation,
  - split dollar life insurance,
  - other fringe benefits.

The audit should be structured to ensure that the attorney-client privilege extends to all information uncovered during the course of the audit, particularly areas of non-compliance that may be identified.* The attorney-client privilege typically does not extend to accountants and other consultants or any individuals other than attorneys.

While perfect compliance is not a practical goal, substantial compliance is. Historically, the IRS has demonstrated significant leniency towards organizations that make a reasonable good-faith effort to ensure compliance of their programs. Indeed, in connection with the current and prior audit initiatives on tax-exempt organizations the IRS has stated that the principal goal is improved compliance and awareness, not the collection of revenue. Therefore, while a current compliance review cannot undo any prior failures, a demonstrated effort at compliance and a commitment to prospective compliance may substantially minimize exposure with respect to prior compliance failures. Perhaps even more important, a compliance review ensuring that the hospital applies best practices for governance and compensation will leave the hospital better positioned to accomplish its civic and charitable mission in the most effective and responsible manner. That, after all, is the fundamental goal to which the standards for tax-exempt organizations, and the IRS enforcement of those standards, are ultimately addressed.

* Some IRS auditing agents have specifically demanded copies of any internal compliance reviews and any list of identified areas of non-compliance.

APPENDIX

Excess Benefit Transactions and Disqualified Persons

Excess benefit transactions and disqualified persons are described in Treas. Reg. § 53.3958-4 and Treas. Reg. § 53.4958-3, respectively. Generally an excess benefit transaction is:

- A transaction in which a disqualified person receives, directly or indirectly, more benefit than that person gave to the organization (essentially, an above-fair-market-value transaction);

- A transaction in which a disqualified person receives unreasonable compensation from the tax-exempt organization; or

- A transaction in which a disqualified person receives payments based on the revenue generated by the tax-exempt organization which otherwise violates the private inurement prohibition.

Payment of reasonable compensation to a disqualified person is not itself an excess benefit transaction (and the regulations provide a rebuttable presumption, discussed below in the context of exempt organization defenses, that may help in establishing that compensation is reasonable). But the regulations require that an item be contemporaneously designated and reported as compensation (i.e., on Form W-2 or Form 990) in order to be treated as compensation for this purpose. Therefore, an item of unreported compensation -- perhaps the reimbursement of an expense that turns out to be unsubstantiated, or the split-dollar insurance benefit of an interest-free loan or equity increase in cash value that is not reported at all -- can never be justified as reasonable compensation even if the total compensation including that amount is objectively reasonable. Instead, the item becomes an automatic excess benefit transaction triggering the excise tax.

Disqualified persons include:

- Any person who was, at any time during the 5-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization;

- A member of the family of an individual described above; or

- Any entity, including a corporation, partnership, or trust or estate, for which such person or such person's family member has 35% of total combined voting power, profit interest, or beneficial interest, determined using constructive ownership provisions.

According to the governing regulations, persons having a "substantial influence" automatically include all voting members of the organization's board; its president, chief executive officer, chief operating officer, treasurer, and chief financial officer; and may include other individuals depending on the facts and circumstances. Thus, compensation to these

individuals, to any individuals having such a position within the five preceding years, and to any of their family members, is a potential excess benefit transaction.