October 2021

Don't Let Intermediate Sanctions Compliance Dictate Your Executive Rewards Strategy

Sector: Healthcare, Not-for-Profit
Topic: Executive Compensation, Intermediate Sanctions

Over the past few years, our mission-focused clients have expressed a renewed and more urgent interest in ensuring that their executive compensation programs and Board of Trustees (or Chancellors, Directors, Governors, Regents, etc.) remuneration practices meet today's legislative, regulatory, and even public scrutiny. Given the heightened exposure of executive compensation in the press and other media outlets, even Boards who have traditionally seen the importance of closely monitoring the compensation of their executive team are taking further steps to ensure that these programs fit well in today's compliance environment. However, in an effort to comply, we find that many clients obscure their executive compensation philosophy (i.e., the organization's approach to defining potential labor markets and offering the balanced mix of compensation elements that will allow them to recruit and retain the caliber and type of executive talent needed to achieve their mission) because they are unclear about how to comply. This is particularly true for not-for-profit healthcare organizations that are subject to Internal Revenue Service (IRS) intermediate sanctions compliance.

Intermediate Sanctions Background

Most not-for-profit organizations qualify for tax-exempt status under Section 501(c)(3) or (c)(4) of the Internal Revenue Code (IRC). To qualify for this tax exemption, the IRC requires, among other things, that none of the earnings of the organization may inure to any private shareholder or individual. As part of the 1996 Taxpayers Bill of Rights II, the IRS may impose stiff penalty taxes—or intermediate sanctions—for what are termed excess benefit transactions to disqualified persons. Prior to having the intermediate sanctions tool, the IRS' only recourse was to strip all or some of the tax-exempt status of these types of organizations. Hence the title "intermediate" sanctions.

Who is a Disqualified Person?

Maybe a better question is: who is an executive? In IRS intermediate sanctions compliance terms, a disqualified person is one who holds certain powers, responsibilities, or interests and is among those who are in a position to exercise substantial influence over the affairs of the organization. Along with Board members and their immediate families, this is also generally construed to mean the top voting executives of the organization and their families, including CEOs, presidents, COOs, treasurers, and CFOs. However, healthcare organizations are complex and require executive management teams whose number and titles

expand well beyond those traditionally considered disqualified persons. While each organization defines "executive" somewhat differently, true top executives are typically included on the senior management team and have input into the operational and long-term objectives of the organization. This means that, while the executive will possess expertise in a specific functional area, they will also typically possess general business/operational acumen and leadership skills. However executives are defined, the philosophy that covers disqualified persons should extend to other senior executives in the organization as well.

Where Can You Buy a Disqualified Person?

The IRC defines an excess benefit transaction as one where the economic benefit provided exceeds the value of the consideration. In other words, you paid more than you needed for what you received. So then, compensation can be deemed reasonable (i.e., not an excess benefit transaction) if it approximates the value that would ordinarily be paid for like services by like enterprises under like circumstances. The key component of balancing compliance with an effective executive compensation philosophy is selecting the right "like enterprises." In our assignments, we spend a significant amount of time working with them to identify the types of organizations that may employ the caliber and type of executive that they feel will help them achieve their organizational mission. Depending on the level of executive expertise or specialization required, each executive position may have its own labor market, or group of comparator organizations. This is a key component in any organization's executive compensation philosophy, and the IRS does not dictate to organizations which organizations can be considered like enterprises.

A recent example would be a study completed for a leading cancer research center. Our initial investigation of potential comparator organizations yielded approximately 250 research centers across North America. After significant further review with our client, we reduced this list to 30 based upon a center's quality of research, renown, and government certifications.

The next issue was identifying like services/circumstances. The 30 centers were fairly evenly split in terms of organization—about half were departments or divisions of universities or hospitals, while about half were independent with their own board. Through research into the key competencies that the organizations required of their top executives, we determined that top executives at the independent research centers generally possessed MDs and were specialists in oncology, like the hospital-affiliated counterparts, but also possessed significantly more business/operations acumen. The top executives at independent research centers run multi-million, sometimes billion, dollar organizations reporting only to the board, so it makes sense that this additional competency would be required and observed. The reason this is important is because this additional competency also commands more compensation, enough that organizations must factor this, as well as other similar discrete differences, into their philosophy and IRS compliance.

It's the Whole Package!

The most persistent confusion we hear from clients and colleagues when we discuss executive reward philosophy and IRS compliance is around what is considered "compensation". For purposes of both the executive compensation philosophy and IRS compliance, the answer is simple: it's the whole package. This includes pay, health and welfare benefits, retirement benefits, supplemental executive benefits and perquisites, and special allowances. The IRS only cares that the value of the total package is reasonable, while your compensation philosophy should delve much deeper and fit your organizational needs.

Certainly not all not-for-profit organizations face this challenge, but some executives are a hot commodity outside the traditional labor market. Not even factoring in the myriad of specialized consulting firms that exist, organizations sometimes see their key executives jump to mature commercial enterprises, start-up companies, and not-for-profits in other sectors. Each of these types of organizations can and do offer a different level and “mix” of total compensation elements. Some have relatively high base salaries and low annual incentives, while some have lower base with stock options. The key then for a not-for-profit organization is to balance its mix of elements to offer the best possible package given legal and cost constraints. An articulated executive compensation philosophy speaks directly to that desired mix.

Deliberate on the Record

It has been a good business and compensation practice to fully document compensation actions taken on behalf of key executives and the reasons for them for years. IRS compliance only adds more reason to deliberate on the record and put all actions in writing.

First, a key to intermediate sanctions compliance is to create a “rebuttable presumption of reasonableness”. In short, if the organization creates this presumption, then the burden of proving that compensation is unreasonable falls back to the IRS. Creating this presumption is also not altogether difficult. Generally, all compensation transactions for disqualified persons must be approved by an authorized body of the organization (or an entity it controls), which is composed of individuals who do not have a conflict of interest concerning the transaction. Prior to making its determination, the authorized body obtained and relied upon appropriate data as to comparability, and it adequately documents the basis for its determination concurrently with making that determination. The authorized body, or its representative, then needs to sufficiently document decisions, including a listing of persons present during deliberations and signatures of those authorized to approve the decision.

Lastly, the IRS has recently begun to issue “automatic intermediate sanctions”. The IRS imposes automatic and immediate tax penalties for any off-the-books or undocumented economic transactions with disqualified persons regardless of whether they can be deemed reasonable. For example, if your organization offers its top executive spousal travel benefits for organization-related business, make sure it is in a formal policy or is included in the top executive’s employment contract.

Final Thought

Intermediate sanctions may be one of the few areas of tax compliance that is less burdensome than effective practice of the executive compensation trade. However, being in compliance is not the same as establishing an executive compensation program that will aid your organization in achieving its mission. It is also one of the areas where the IRS has clear information available on its website: https://www.irs.gov/charities-and-nonprofits.