HEALTHCARE FINANCE NEWS

IRS eyes transparency in executive compensation

By *John Andrews, Contributing Writer* | 08/01/08 | COMPENSATION 0808

Proper maintenance of records, complete reporting on forms and strict adherence to regulations should keep not-for-profit hospitals in good standing with the Internal Revenue Service over executive compensation, financial experts say.

And if there was ever a time when propriety mattered, it's now.

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Although in the IRS crosshairs since the early 1990s, executive compensation at 501(c)(3) corporations has apparently become a much bigger target in the past couple of years, with Congress beginning to seriously investigate these practices.

What precipitated the sudden interest in how not-for-profit hospitals pay their administrators? There are several factors, but Richard Lucash, partner with Wellesley, Mass. -based Lawrence Associates, says the buildup has been occurring over several years.

"This is not a new topic by any means," he said. "The whole focus on the amount of compensation and reporting has a long history with the IRS. As far back as 1992, the IRS did 20-some audits of particular hospitals on compensation and issued audit guidelines to its agents."

Basically, the government is serving in a watchdog role on the compensation issue, fixating on not-for-profit hospitals' fiduciary responsibility to their communities by providing charity care and other public services. In 2004, the IRS reviewed compensation data based on compliance check letters sent to 1,223 organizations and examinations of 782 organizations. Two years later, the agency developed a "good governance" initiative that included new, more detailed 990 reporting forms and intermediate sanctions aimed at those who do not comply. Federal legislators, such as Sen. Charles Grassley (R-IA), have held formal inquiries into executive compensation reporting methods and whether the amounts allocated are justified.

"Here in Boston, there has been a series of newspaper articles about charitable foundations that were paying 'excessive' compensation, which generated attention from the IRS and Congress," Lucash said. "This has become Grassley's hot issue; he's held hearings on hospital compensation levels and reporting. It always tends to go hand-in-hand with the focus on community benefits."

Healthcare executives are modestly paid. Data from the Hospital & Healthcare Compensation Service reveals that the average CEO/administrator salary, including bonuses, in 2006 was $315,891.

However, changing market dynamics indicate that the stakes are growing and that top-flight executives are commanding more of a premium. As healthcare consolidation creates increasingly larger provider networks and conventional hospitals focus on specialty services, competition for landing seasoned pros is getting fiercer, noted Bill Heck, managing principal of Denver-based Harlon Group.

"Talent is in big demand, especially for those who are experienced in running specialty groups like pediatric hospitals and cardiology centers," he said. "These people have a special skill set, like fund-raising. The reality is that those skills are quite valuable."

IRS officials believe there are significant reporting issues with not-for-profit hospitals, indicated by the fact that 30 percent of the organizations receiving compliance check letters routinely amend their 990 forms. The new 990s have been revised to provide more transparency, placing more prominence on compensation issues, including

organizational criteria for setting pay levels. Schedule H is specifically for hospitals, delving into community benefit and joint ventures.

“We advise hospitals to prepare a pro forma 990 so that they can see their public face,” said Lindalee Lawrence, founder of Lawrence Associates. “Over the years, we’ve heard complaints that the numbers weren’t comparable, but the new 990 is different in terms of policy questions and levels of disclosure, including items that historically haven’t been disclosed, like deferred compensation plans.”

Those found to be non-compliant could face intermediate sanctions, consisting of taxes on excess benefits and compensation.

“This is not just a matter of ethics, but a matter of compliance,” Lucash said. “If you don’t jump through the right regulatory hoops, you can be liable for penalty taxes.”

There is a regulatory safe harbor from intermediate sanctions, most notably for demonstrating that executive compensation falls within a normal range for comparable positions in comparable institutions. So far, the provision has helped shelter some hospitals, Heck said.

Adhering to the tenets of the Sarbanes-Oxley Act of 2002, which requires financial disclosure on changes in an organization’s financial condition or operations, also meets good governance standards, Lawrence said.

Lawrence reiterated that for not-for-profit hospitals to be properly situated, they need to “seek safe harbors for intermediate sanctions, practice Sarbanes-Oxley and do a pro forma 990.”