of their compensation arrangements. It is good for the companies and the workers, with the kind of identity of interest that often permeates representing closely held businesses. There will always be some concern when compensation appears to be outsize and where "disguised dividend" earmarks may be present. Yet in many (if not most) cases, the following mix of the totality of the circumstances will probably make everyone feel comfortable:

- Compensation arrangement and contract struck prospectively, not retroactively;
- Compensation, even in outsize years, considered across the historical perspective that may include inadequate compensation in the past;
- Comparative data about other similarly situated companies;
- Comparative data about other similarly situated executives;
- Personal effort expended, regardless of what other executives may do;
- Dividend history; and
- Capital investment criteria for an independent investor. ■

Is Your Exempt Organization Meeting the Rebuttable Presumption? It's Time for Tax-Exempt Hospitals to Review Their Compensation Policies

By Heather Szajda and Derek Kung*

In May 2006 the Service commenced its "Hospital Compliance Project," providing exempt organizations a glimpse of what issues may be of concern to it. The project focused on community benefit and executive compensation. Based on past reporting, the Service also examined the compensation practices of 20 hospitals. Nearly three years later, the Service has issued its final report, which indicates a likely increase in scrutiny of the initial contract exception and the rebuttable presumption.

Tax-exempt organizations are prohibited from excessively compensating their employees, officers, and directors. An excess benefit transaction is defined as a "transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services)." Treas. Reg. § 53.4958-4(a). If compensation is deemed an "excess benefit," then Code section 4958(a) imposes a penalty equal to 25% of the excess benefit amount upon the disqualified person.

Mechanisms for Protecting Against the Excess Benefit Prohibition

Exempt organizations often rely on the initial contract exception when first hiring an executive and then comply with the requirements of the rebuttable presumption in successive years when determining said executive's compensation. The excess benefit prohibition applies to a "disqualified person," which Regulation section 53.4958-3(a) defines as someone who was in a "position to exercise substantial influence over the affairs" of the exempt organization. Because of the substantial influence requirement, the Regulation's initial contract exception excepts from Code section 4958 "any fixed payment made to a person pursuant to an initial contract." To qualify for the initial contract exception, the compensation arrangement must satisfy the following criteria: (1) the executive may not be a disqualified person prior to entering into the contract with the organization; (2) the contract provides a fixed formula for determining the executive's compensation; (3) the compensation must be for specified services or property; (4) no person can exercise discretion as to the amount of compensation or whether to pay or not pay compensation; and (5) the executive must substantially perform such executive's obligations under the contract. Treas. Reg. § 53.4958-4(a)(3)(i)-(iv).

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For years, tax-exempt organizations have relied on Regulation section 53.4958-6, as a safe harbor when setting executive compensation. Regulation section 53.4958-6(a) provides a rebuttable presumption of reasonableness if (1) the compensation arrangement is approved in advance by an authorized body of the tax-exempt organization composed of individuals who do not have a conflict of interest with respect to the arrangement, (2) the authorized body obtains and relies upon appropriate comparable data prior to making the determination, and (3) the authorized body contemporaneously documents the basis for the determination at the time the decision is made. The three-prong requirement for the rebuttable presumption should be the minimum standard a tax-exempt organization incorporates into a compensation policy that is followed for setting compensation of employees, officers or directors (collectively, "employees").

A tax-exempt organization should follow a compensation policy adopted by the governing body (the board of directors or trustees) of the organization for determining annually compensation of employees. The compensation policy should define the members of the authorized body, as provided under Regulation section 53.4958-6(c), as either the governing body of the organization, a committee of the governing body (as permitted under state law), or a committee comprised of members of the governing body and other parties authorized to act by the governing body under applicable state law. Members of the authorized body should be free from conflicts of interest with respect to the particular transaction.

A compensation policy should describe the comparability data the governing body deems appropriate for use as comparable data. Regulation section 53.4958-6(c)(2) provides that appropriate comparable data for determining reasonableness of compensation may include "compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person." Many organizations obtain comparable data from information found on Forms 990 filed by similar organizations or use independent consultants or firms to advise on compensation in the applicable industry.

Lastly, Regulation section 53.4958-6(c)(3)(i) requires decisions concerning compensation be documented adequately by the authorized body. The regulation requires that adequate documentation of the decision include written or electronic records of the authorized body that note: (1) the terms of the approved transaction and the date of approval; (2) the members of the authorized body present during the debate on the approved transaction and those who voted on it; (3) the comparability data obtained and relied upon by the authorized body and how the data was obtained; and (4) any actions taken with respect to consideration of the transaction by a member of the authorized body who had a conflict of interest with respect to the transaction. Furthermore, under Regulation section 53.4958-6(c)(3)(ii), "if the authorized body determines that reasonable compensation for a specific arrangement…is higher or lower than the range of comparability data obtained, the authorized body must record the basis for its determination." Documentation by the authorized body must occur contemporaneously.

If an organization creates a rebuttable presumption of reasonableness, the Service may still impose a penalty "if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body" under Regulation section 53.4958-6(b). For certain fixed payments under a contract, the Service may be limited to rebuttal evidence relating to the facts and circumstances as of the date the parties entered into an employment contract.

The Redesigned 990

In 2007, the Service announced that the Form 990 information return would be redesigned for the first time since 1979. Part VII of Form 990 requires disclosure of compensation of certain key individuals, and the Service has created a comprehensive Schedule J, which closely tracks compensation of such key individuals. Schedule J tracks all forms of compensation to certain key individuals, enabling the viewer to determine exactly how exempt organizations compensate such individuals. (Interestingly, the amounts reported in Part VII may differ from those in Schedule J. Schedule J requires inclusion of certain benefits and de minimis amounts not required to be reported in Part VII.) Part VI of the Form 990 requires exempt organizations to provide information regarding certain governance issues, such as the existence of a conflicts of interest policy or a compensation policy. Specifically, line 15 of Part VI requires organizations to describe the internal governance procedures it uses to satisfy the requirements of the rebuttable presumption. The instructions to the Form 990 state that "[e]ven though governance, management, and disclosure policies and procedures generally are not required under the Internal Revenue Code, the IRS considers such policies and procedures to generally improve tax compliance."

Findings of the Hospital Compliance Project

In a February 2009 summary report, the Service released the findings of the Hospital Compliance Project and noted several important findings: (1) nearly all the hospitals reported compliance with the regulations for meeting the rebuttable presumption of reasonableness for the compensation of employees, (2) the average and median compensation reported was $1,400,000 and $1,300,000 respectively for a focus

group of 20 hospitals that were selected for examination based on compensation amounts, and (3) although the compensation appears to be high, most of the amounts were upheld as established pursuant to the rebuttable presumption standard. Lois Lerner, in a press briefing issued on February 12, 2009, specifically addressed the compensation issue and the results of the Hospital Compliance Project and stated that the Service needs to closely examine the quality of comparability data used to establish reasonableness (specifically whether compensation amounts paid by for-profit organizations should be allowed) and the impact of the initial contract exception on compensation paid by hospitals.

Conclusion

While discussing the possibility of a trend in executive compensation of nonprofit hospitals moving toward the high end of the spectrum, the Service's TE/GE Commissioner, Steven T. Miller, stated (in an interview with the American Health Lawyers Association): "When the river rises, all boats rise. There's a question as to whether that was the intention of the rebuttable presumption concept." It appears that the issue of reasonable compensation will be a focus of the Service for the present time. Every tax-exempt organization should review its compensation policy to determine whether the policy appropriately incorporates the three-prong test set forth in Regulation section 53.4958-6, and sets forth standards that exceed the minimum for compensation data comparison. Hospitals should be on notice that the Service is looking carefully at compensation arrangements and consider whether past practices will continue to satisfy the rebuttable presumption standard. ■

Qualified Intermediary Program Reform

By Kathryn Morrison Sneade*

Last year, the qualified intermediary ("QI") program, which essentially allows foreign financial institutions to act as U.S. withholding agents by entering into an agreement with the Service and promising to abide by various terms, came under widespread scrutiny as a result of reported abuses of the program by the foreign banks UBS and LGT. As a result, proposals for reforming the program have been presented by the Service, the Senate Permanent Subcommittee on Investigation ("PSI"), and, most recently, the Obama administration. Many of these reforms would impose significant burdens on QIs, which will affect foreign financial institutions' ability and desire to participate in the QI program. However, the Obama administration's proposed reforms would also have serious negative consequences for non-QIs, leaving foreign financial institutions with a difficult choice.

Overview of the Program

The QI program was established in 2000 to encourage compliance with the U.S. withholding requirements of Code section 1441 and the corresponding Treasury regulations and to enhance reporting on U.S. persons' foreign account activity. Under the program, foreign financial institutions that have signed a QI agreement agree to take primary responsibility for withholding tax from payments to foreign persons and may also agree to take on primary Form 1099 responsibility for certain payments to U.S. persons. QIs must obtain a Form W-9 (indicating that the client is a U.S. person), Form W-8BEN (indicating that the client is a non-U.S. person who beneficially owns an account held in the name of an intermediary), or other appropriate documentation from each client that buys or sells U.S. securities through an account for which the foreign financial institution is a designated QI participant. All QIs are required to have "know-your-customer" ("KYC") procedures in place for collecting documentation regarding account holders' identities, and therefore, they are thought to be in a better position to accurately determine the residency and nationality of the account holders than other U.S. withholding agents.

As an incentive for financial institutions to join the program, QIs are not required to disclose the identities of non-U.S. account holders in the reporting and withholding process. Instead of filing an individual Form 1042S (used to report foreign persons' U.S. source income subject to withholding) for each non-U.S. client filing a W-8BEN form, QIs may pool the "reportable amounts" of U.S. source income paid to all non-U.S. accounts in the QI program and file a single Form 1042 for each category of U.S. source income paid to those accounts, remitting withheld taxes to the Service on an aggregate basis. In contrast, a QI that has taken on primary Form 1099 responsibility must file an annual Form 1099 with the Service for each U.S. client receiving "reportable payments" of U.S. source income in a QI-designated account. UBS and LGT reportedly helped many U.S. clients with U.S. securities avoid disclosure by helping them to establish foreign entities to hold the securities in a new account. The banks would then accept W-8BENs from the new accounts and treat them as accounts held by non-U.S. entities,

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