Important Content Note:

This technical assistance resource was developed prior to the August 2017 release of the Health Center Compliance Manual by the Health Resources and Services Administration’s (HRSA) Bureau of Primary Health Care (BPHC). The BPHC Compliance Manual, issued August 2017, indicates where PINS, PALs and other program guidance are now superseded or subsumed by the BPHC Compliance Manual.

See:
Compensating Health Center Executives

As with any successful organization, it is clear that a strong management team is essential to success. Accordingly, recruitment and retention of competent management staff should be a health center priority. In a highly competitive market for well-qualified health care executives, compensation obviously plays an important role in both recruitment and retention. This Information Bulletin discusses important legal considerations in compensating health center executives, focusing primarily on federal income tax law, with reference to federal grant cost principles.

The fundamental rule for all health center compensation decisions is that all compensation paid must be “reasonable.” The principle of “reasonable compensation” is embedded in both federal income tax law and federal grant law.

Health centers typically are tax-exempt under Section 501(c)(3) of the Internal Revenue Code (“IRC”). In order to obtain and retain federal tax exemption, no part of an organization’s net income may “inure” to the benefit of any private individual. While paying compensation to employees clearly provides a benefit to them, a long line of court cases and Internal Revenue Service (“IRS”) rulings has made it clear that paying “reasonable” compensation for services provided by employees is not viewed as private inurement and, accordingly, is permissible.

Similarly, the federal cost principles, i.e., the rules for determining what costs can and cannot be charged to federal grant awards, provide that employee compensation is an allowable cost to the extent that compensation paid is reasonable for the services rendered.¹

¹ See 2 C.F. R. Part 200, Subpart E, Cost Principles. Note, however, that Congress may impose restrictions on the use of appropriated funds. For example, for Fiscal Year 2016, the maximum allowable salary that can be charged to a health center grant award issued after January 10, 2016, was $185,000.10.
It is important to note that, under both IRC Section 501(c)(3) and the federal cost principles, all compensation received by an employee must be taken into account in assessing “reasonableness.” This would include, for example, base salary, the value of any incentive compensation, and the value of fringe benefits and other perquisites provided to executives, e.g., life insurance, automobile allowance, etc.

THE BASICS

Reasonable Compensation

There is no specific formula for fixing the “reasonable compensation” of a particular health center executive, such as the Chief Executive Officer (“CEO”). Reasonableness is determined by the “facts and circumstances” of each individual case. However, the most important factor always is the prevailing rate of compensation paid to comparably qualified and experienced persons performing similar functions for similar organizations in the community, e.g., salary comparability studies.

It is important to note that the compensation practices of for-profit organizations can be used in salary comparability studies. Thus, the salary paid to the Chief Financial Officer (“CFO”) of a similarly sized private medical group or clinic in the community could be used as a basis to establish the reasonableness health center’s CFO. An offer letter from a comparable organization to a prospective executive employee, quoting a specific salary, also can be used to establish the reasonableness of the compensation that a health center offers to that individual.

There are numerous sources of salary comparability data. For example, the National Association of Community Health Centers, Inc. (“NACHC”) annually publishes the Executive and Clinician Compensation & Benefits Report for Health Centers. Of course, to be useful in defending any challenge to the reasonableness of an executive’s compensation, salary data must be current and describe salaries paid by organizations that truly are comparable to a particular health center.

Alternatively, a center can commission a salary comparability study performed by an appropriately qualified compensation expert. IRS regulations provide that the center’s Board of Directors can rely on a written opinion from such an expert.

In any event, salary comparability studies are best used as a benchmark to guide a health center’s compensation decisions. As previously noted, whether a particular executive’s compensation is “reasonable” depends upon the facts and circumstances of the particular situation. For example, comparability studies usually include a range of salaries paid by similar organizations for a particular position. A center should not feel constrained to pay only the “average” salary reported for that of the compensation paid to a maximum allowable salary that position if an executive or an applicant for an executive position clearly merits higher compensation. Similarly, a center is not necessarily limited to paying no more than the “high” salary reported. Factors, such as an individual’s longevity with the center, individual contribution to the center’s mission, the difficulty of recruiting a replacement, unique skills, etc., always can be considered in determining reasonableness. However, a center’s burden to document the reasons for its compensation decisions increases significantly as compensation approaches or exceeds the high end of the “comparable” range.
Unreasonable Compensation

Executive compensation that exceeds the bounds of reasonable compensation will result in a cost disallowance if charged to a federal grant, i.e., the “unreasonable” amount will not be an allowable cost under the grant. While this may not be problematic if a health center can make up the difference with non-grant funds\(^2\), the federal tax consequences can be much more significant.

As discussed above, the absence of private “inurement” is a condition of obtaining and retaining federal income tax exemption. Therefore, paying unreasonably high compensation to key executives and other “insiders” of an organization can result in revocation of an organization’s tax exemption. As a practical matter, that rarely happens. The IRS is reluctant to revoke an organization’s income tax exemption because that is likely to drive the organization out of business, thereby depriving the community of the charitable services the organization provided. Thus, historically, the IRS did not have an effective means to police the compensation practices of tax-exempt organizations.

\[\text{... the legislation gave the IRS the authority to impose tax penalties on certain individuals who receive unreasonably high compensation...}\]

INTERMEDIATE SANCTIONS

That state of affairs changed in 1995 when Congress enacted Section 4958 of the IRC. Section 4958 is also known as the “intermediate sanctions” provision because the legislation gave the IRS the authority to impose tax penalties on certain individuals who receive unreasonably high compensation and those who knowingly approve such compensation, those penalties being less extreme than outright revocation of the organization’s tax exemption.

The penalties can be substantial. At a minimum, an individual who receives unreasonably high compensation, technically known as an “excess benefit,” must return the amount of the excess benefit, plus interest, to the organization.

Further, the individual can be liable for a tax in the amount of 25% of the excess benefit. That penalty increases to a tax equal to 200% if the excess benefit is not corrected, i.e., returned with interest, before the IRS issues a deficiency notice demanding payment. Organization managers, such as health center board members, who knowingly approve an excess benefit transaction, are liable for a tax in the amount of 10% of the excess benefit up to $20,000.00.

The Section 4958 tax penalties are targeted at key executives and the board members of tax-exempt organizations, referred to as “disqualified persons” and “organization managers” in the statute.

\(^2\) Section 330 of the Public Health Service Act permits the use of grant-related income (both pledged and excess income) for purposes that further program objectives and that are not otherwise prohibited. The federal cost principles or other compensation limitations that may be attached to federal appropriations do not apply to such expenses, although the health center must nevertheless be sure to deliver the scope of project described in the approved application. See Policy Information Notice (PIN) 2013-01, Health Center Budgeting and Accounting Requirements, (March 18, 2014).
Disqualified Persons

It is extremely important that health centers identify their personnel who are "disqualified persons" under Section 4958 as they are the individuals at risk of having tax penalties imposed if they receive an "excess benefit." Most, if not all, health center executives are likely to be disqualified persons.

Certain persons automatically are deemed to be disqualified persons. They include:

♦ Chief Executive Officer (CEO)
♦ Chief Operating Officer (COO)
♦ Chief Financial Officer (CFO)

However, anyone who is in a position to exercise "substantial influence" over the affairs of a health center is considered to be a disqualified person, regardless of the title that the person holds. For example, a center’s Chief Medical Officer may well be a disqualified person depending on the particular “facts and circumstances.” The IRS regulations specifically note that a person who has managerial control over a discrete segment of an organization may be in a position to exercise substantial control over the affairs of the entire organization. Other factors tending to show substantial influence include having the authority to control or determine a significant portion of the organization’s capital expenditures, operating budget, or compensation of employees, and having managerial authority or serving as a key adviser to a person with managerial authority. Note that being in the position to exercise substantial influence is all that is required in order to be a disqualified person, even if the person did not actually exercise that influence.

There is a “safe harbor” for individuals who receive economic benefits, i.e., salary and taxable benefits, of less than $120,000.00 per year. In that case, unless the employee is specifically classified as a disqualified person, i.e., is the CEO, COO, or CFO, or has equivalent duties, or is a family member of a disqualified person, the employee will not be treated as a disqualified person.

Organization Managers

As previously noted, an organization manager who knowingly participates in an excess benefit transaction, i.e., the payment of unreasonable compensation, is subject to a tax in the amount of 10% of the excess benefit. Under the IRS regulations, an organization manager includes:

♦ Board members
♦ Officers
♦ Any person having powers or responsibilities similar to those of board members and officers, regardless of title.

3 Board members also are automatically considered to be disqualified persons, but they are unlikely to face reasonable compensation issues since health centers typically do not compensate board members for their service as board members. However, board members who receive excessive compensatory benefits from a center, e.g., substantial gifts or other "perks," could run afoul of Section 4958. Further, as discussed in more detail below, board members also are "organization managers" who could be liable for knowingly approving unreasonable compensation for executive staff.

4 The IRS regulations implementing Section 4958 are codified at 36 C.F.R. § 53.4958-0 through § 53.4958-7.

5 It should be noted that an outside organization (other than an organization that is tax-exempt under Section 501(c)(3)) could be a "disqualified person" under Section 4958 if the organization were in a position to exercise substantial influence over the tax-exempt organization. Thus, health center managers who knowingly approve an excess benefit transaction with the organization, such as unreasonably high compensation to an influential vendor, could be liable for tax penalties.

6 For calendar 2016. This amount is subject to annual cost-of-living adjustments.
A person is an officer of an organization if the person is specifically designated as an officer under the articles of incorporation or bylaws, or if the person regularly exercises general authority to make administrative or policy decisions on behalf of the center. As a practical matter, board members and officers of health centers always will be treated as organization managers and, accordingly, are at risk if they knowingly and willfully approve an excess benefit transaction, i.e., unreasonable compensation of a disqualified person.

Similarly, a health center CEO is likely to qualify as an organization manager because the CEO regularly makes administrative and policy decisions. Indeed, a health center CEO typically hires and fires all other center staff, and could be subject to penalties for knowingly and willfully approving excessive compensation of a subordinate executive who is a disqualified person. However, an organization manager can rely on a reasoned written opinion of an appropriate professional (e.g., an attorney, CPA, independent valuation expert) regarding a compensation decision and, in that case, would be protected from sanctions even if the IRS subsequently holds that the compensation was excessive.

Moreover, the risk of liability of all parties can be virtually eliminated if the board of directors follows the “rebuttable presumption” procedures for setting executive compensation discussed below.

**Timing Issues**

**IDENTIFYING DISQUALIFIED PERSONS**

Timing is important in identifying disqualified persons. A person is a disqualified person if he or she was in a position to influence an organization’s affairs (or held one of the positions deemed to be a disqualified person) at any time within the five-year period preceding a compensation transaction. For example, a physician served as a health center’s Chief Medical Officer and had sufficient influence to be classified as a disqualified person until January 1, 2012, at which time she gave up her managerial duties and became a staff physician. The physician’s compensation is subject to Section 4958 standards until January 1, 2017.

**INITIAL CONTRACT EXCEPTION**

Conversely, Section 4958 does not apply to any fixed payment made to an executive under an initial contract if the person was not a disqualified person at the time that the initial contact was signed. Thus, a newly hired health center executive (such as a CEO) would not be subject to sanctions under Section 4958 if he received “unreasonable” compensation as part of his initial contract, nor would board members be liable for approving the compensation.

This so-called “one bite” rule applies only if there is a written employment contract, and only if the compensation in the contract is “fixed.” Compensation is “fixed” if there is specified amount of cash (and other non-cash compensation) stated in the contract or if compensation is determined by a formula that is specified in the contract and is not discretionary. For example, cost-of-living increases based on a particular consumer price index identified in the contract, or increases based on a percentage in the center’s net income specifically stated in the contract, would qualify as a “fixed” payment. (Incentive compensation is discussed in more detail below.)

The “one bite” rule applies only so long as there is no material change in the terms of the initial contract. For example, if a newly hired CEO were awarded a substantial raise in the second year of a five-year employment contract (the raise being in addition to the compensation called for in the initial contract), the raise would be treated as a new contract for Section 4958 purposes. Since the CEO was a disqualified person at the time he received the raise, his total compensation would have to be analyzed for compliance with Section 4958. Similarly, compensation
paid to a CFO promoted to CEO would have to be reviewed for compliance because the CFO would have been a disqualified person when he was promoted to CEO.

Note that the exception for initial contracts only eliminates the potential for the assessment of Section 4958 tax penalties. It does not eliminate the possibility, however remote, that the IRS could question executive compensation on the grounds that it constitutes private inurement. Accordingly, centers are well advised always to perform a reasonable compensation analysis when hiring and promoting executives.

**Computing Total Compensation**

All items of executive compensation provided by a health center must be taken into account when determining the reasonableness of compensation. This includes:

- All forms of cash and non-cash compensation, including, salary, fees, bonuses, severance payments, deferred and non-cash compensation, personal use of an automobile, etc.;

- Taxable and nontaxable fringe benefits, except fringe benefits specifically excluded from gross income under Section 132 of the IRC (e.g., business use of an automobile); and

- All other compensatory benefits, whether or not included in gross income for income tax purposes.

Further, certain types of benefits sometimes provided to executive staff will be treated as an excess benefit and subject to Section 4958 tax penalties if they are not treated as compensation and properly reported as such on the employee’s Form W-2 and on the health center’s Form 990. For example, expense reimbursements made to an executive pursuant to a so-called “accountable plan” (i.e., where expenses must be substantiated and certain types of per diem arrangements) are disregarded under Section 4958. However, expense reimbursements under arrangements that are not an accountable plan must be reported as compensation. Otherwise, they automatically will be treated as excess benefits and be subject to tax penalties. Similar rules apply to the value of the private use of a health center’s automobile and most other non-salary benefits. All must be reported as compensation or be treated as an “excess benefit.” If they are reported as compensation, they will be aggregated with all other types of compensation for purposes of determining the “reasonableness” of the total compensation package paid to the executive.

**Deferred Compensation**

The value of an executive’s services performed in prior years is taken into account in determining the reasonableness of compensation that is paid (or vests, i.e., the recipient has a legal right to payment) in subsequent years. Health centers sometimes offer key executives a retention incentive, i.e., consideration for the executive’s continued employment with the center. For example, a center agreed to pay its CEO a $50,000.00 “bonus” if she stayed with the health center for the full term of a five-year employment contract. She was paid the bonus at the end of the fifth year. For purposes of Section 4958, the $50,000.00 payment is prorated over the five (5) years of the contract, i.e., $10,000.00 is “deemed” to be compensation each year of the contract. There would be an excess benefit transaction only if the sum of the CEO’s actual compensation plus the $10,000.00 “deemed” compensation exceeded “reasonable compensation” in a particular year. The sum of the excess benefits, if

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7 Note that the portion of the cost of a health-center-furnished automobile that relates to personal use is unallowable under the federal cost principles without regard to the tax treatment. See 2 C.F.R. § 200.431 (f).
any, paid over the five year contract period would be aggregated for purposes of Section 4958 penalties and treated as an excess benefit transaction in the year that the bonus was actually paid.

Avoiding “Excess Benefit” Transactions: The Rebuttable Presumption of Reasonableness

Clearly, the way to avoid the unpleasant income tax consequences of an excess benefit transaction when compensating health center executives is to make sure that their compensation always is “reasonable” under the circumstances. In that regard, the tax regulations provide a “rebuttable presumption” that compensation paid is reasonable if the board of directors follows certain prescribed steps in making executive compensation decisions. The benefit of the rebuttable presumption is that it shifts the burden of proof to the IRS to establish that compensation paid is unreasonable instead of the health center having to prove that the compensation is reasonable.

The following procedures must be followed in order for the rebuttable presumption of reasonableness to apply:

♦ The compensation package must be reviewed and approved by the board of directors or an appropriate committee of the board;

♦ The board, or a committee of the board, must obtain and rely on appropriate comparability data showing the compensation levels paid by similar organizations for comparable positions. (IRS regulations allow small organizations with annual receipts of $1,000,000 or less to document salary comparability by obtaining compensation information from three (3) similar organizations in the community or in similar communities);

♦ The comparability data must be current as of the time of the review, and the data must be reviewed before the compensation decision is made or paid; and

♦ The basis for the decision must be documented on the record, i.e., in the minutes of the board or committee meeting. Documentation should include a description of the compensation to be paid (including all benefits and fringe benefits); the date of approval (which should be before the effective date of the approved compensation arrangement); and the comparability data relied on and how it was obtained. In particular, if the board (or board committee) determines that the compensation to be paid to an executive exceeds the comparables that it has reviewed, it must document the reasons why it has decided that the compensation to be paid is, nevertheless, reasonable under the circumstances.

Note that while a health center board may delegate executive salary comparability analysis to a board committee, as permitted by the IRS regulations and, under the applicable federal health center regulations, is expected to delegate all personnel hiring decisions (and specific compensation offers) to the CEO, the health center board must have the final responsibility for establishing compensation schedules (i.e., ranges for particular categories of employees) for all health center staff.
INCENTIVE COMPENSATION

Tax Considerations

Health centers, like many other tax-exempt organizations, sometimes provide incentive compensation to executive staff as a means of encouraging and rewarding outstanding performance or otherwise promoting the center’s objectives. From the perspective of federal income tax exemption, an incentive arrangement must not permit private inurement, i.e., unreasonably high compensation of health center “insiders,” such as executive staff. Accordingly, the starting point for analyzing an executive incentive compensation plan is that it must not result in an executive receiving unreasonably high compensation. As noted above, that could result in the imposition of tax sanctions on executives who are treated as disqualified persons.

However, the IRS also is concerned about the methodology for awarding and computing incentive compensation. In short, the incentive arrangement must promote the charitable purposes of an organization, e.g., enhance quality and/or expanded services, reduce costs, increase patient satisfaction, etc. Incentives that simply produce more revenue—without an affirmative impact on the organization’s charitable programs—are not favored.

In particular, the IRS looks closely at so-called “revenue sharing transactions” which encompass any compensation arrangement, including incentives, that is based in whole or in part on the revenue of one or more activities of a tax-exempt organization. Incentive compensation based on a percentage of collections is a classic example of a revenue sharing transaction. This concern is grounded in the language of Section 501(c)(3) which provides, in part, that “no part of the net earnings” of a tax-exempt organization may “inure” to the benefit of private parties. Hence, the IRS takes the position—supported by the courts—that impermissible private inurement can take place if the manner of calculating compensation essentially conveys an interest in the organization’s net earnings. This could happen, for example, if an executive received incentive compensation based on a percentage of net income of a health center without regard to the executive’s individual contribution to the center’s mission. Therefore, any incentive compensation arrangement based on the revenue of the center should be carefully structured to assure that it promotes the center’s charitable health care mission.

The IRS outlined the factors that it considers in determining whether an incentive compensation arrangement constitutes private inurement or impermissible private benefit in its fiscal 2000 Continuing Professional Education (“CPE”) Technical Instruction Program. Although the factors listed specifically relate to physician incentives, they generally are applicable to all employee compensation arrangements.

1. Was the compensation arrangement established by an independent board of directors or by an independent compensation committee of the board?

2. Does the incentive compensation arrangement result in total compensation that is reasonable (under the standards discussed above)?

3. Was there an arm’s length relationship between the organization and the recipients of the compensation, or did the recipients unduly influence the award of the incentive?

8 The CPE text is used to train IRS field agents. Although the analyses and conclusions in the text are not legally binding on the IRS and cannot be cited as precedent, it is useful as a guide to the IRS’s approach to certain issues.
4. Does the compensation arrangement include a ceiling or reasonable maximum on the amount an employee may earn to protect against projection errors or substantial windfall benefits? (Note that the IRS regulations under Section 4958 specifically indicate that a “cap” on a compensation arrangement is a relevant factor in determining the reasonableness of compensation.)

5. Does the incentive program have the potential for reducing the charitable services or benefits that the organization would otherwise provide by diverting resources from those programs to executive compensation?

6. Does the compensation arrangement take into account data that measures quality of care and patient satisfaction?

7. If the incentive arrangement depends on net revenues, does the arrangement accomplish the organization’s charitable purposes, such as keeping actual expenses within budgeted amounts, where expenses determine the amounts the organization charges for services?

8. Does the arrangement transform the principal activity of the organization into a joint venture?

9. Is the arrangement merely a device to distribute all or a portion of the organization’s profits to persons who are in control of the organization?

10. Does the compensation arrangement serve an actual and apparent business purpose of the exempt organization, such as to achieve maximum efficiency and economy in operations independent of any purpose to operate the organization for the impermissible direct or indirect benefit of the persons receiving incentive compensation?

11. Does the compensation arrangement result in no abuse or unwarranted benefits because, for example, prices and operating costs compare favorably with those of other similar organizations? (The CPE text further notes that this should include effective controls to avoid increases in compensation predicated merely on increases in fees charged to patients.)

12. Does the compensation arrangement reward the employee based on services actually performed, or based on performance in an area where the employee performs no significant function?

While an incentive compensation arrangement that provides unreasonable compensation to a health center executive certainly will not pass IRS scrutiny, the relative importance of any of the other individual factors depends on the facts and circumstances of each particular case. Health centers should analyze their incentive compensation arrangements in light of all of the relevant factors.

Federal Grant Cost Principles

Incentive compensation, when based on cost reduction, efficient performance, or some other discernible benefit to a grant-funded program, is an allowable cost under the federal cost principles. In addition, the overall compensation paid, including the incentive, must be “reasonable.” However, the federal cost principles impose two other important requirements. Incentive compensation must be paid (or accrued):

♦ Pursuant to an agreement entered into before the services generating the incentive were performed, or

♦ Pursuant to an established plan followed by the organization so consistently as to imply, in effect, an agreement to make such payment.
In short, the federal cost principles require that an incentive compensation arrangement be in place, explicitly by contract or implicitly by reference to established policies and procedures, before the services on which the incentive payment is based are performed.

**CONCLUSION**

Establishing an appropriate and effective compensation system is essential to attracting and retaining talented health center executives. However, in order to avoid potential income tax penalties and cost disallowances under federal grant awards, the compensation system must ensure that compensation paid is reasonable under the circumstances. In that regard, obtaining and utilizing appropriate salary comparability data is crucial. Documenting the basis upon which compensation arrangements are determined is equally important.