

CEO and Senior Executive Compensation – Legal Considerations for Health Centers

As with any successful organization, a strong management team is essential. The way a competent Chief Executive Officer (CEO) is recruited and retained should be a priority for the board. Likewise, a competent senior management team should be a priority for the CEO.¹ Compensation plays an important role in this process, especially when well-qualified candidates are hard to find. This document covers legal considerations related to compensating health center executives under federal income tax law, and federal grant cost principles.

The main rule used to guide how much compensation to offer to health center executives is that payment and other benefits must be “reasonable.” The idea of “reasonable compensation” is part of both federal income tax law and federal grant law. Compensation, for both IRC Section 501(c)(3) and the federal cost principals, includes base salary plus the value of incentives, the value of fringe benefits, and other privileges offered to health center executives, like life insurance, automobile allowance, etc. (known as perquisites).

Health centers typically are tax-exempt under Section 501(c)(3) of the Internal Revenue Code (IRC). To operate as a tax-exempt organization, net income may not “inure” to benefit any private party. In other words, people with a close relationship to an organization cannot personally or unfairly benefit from it. While paying employees is clearly a benefit to the employee, many courts and Internal Revenue Service (IRS) rulings have found that paying “reasonable compensation” for employee services is not the same as “private inurement.” It is considered to be fair and allowed.

Similarly, the federal cost principles – the rules that define what costs can be charged to Health Resource and Services Administration (HRSA) grant awards – allow reasonable compensation to be paid to employees for their services.²

¹ Please note that additional information on board oversight of the CEO can be found in the Governance Guide for Health Center Boards, Chapter 7: CEO Oversight and Partnership (see <https://www.healthcenterinfo.org/details/?id=2302>).

² See 45 C.F.R. Part 75, Subpart E, Cost Principles. Note, however, that Congress may impose restrictions on the use of appropriated funds. For example, for Fiscal Year 2020, the maximum allowable salary that can be charged to a health center grant award, as of January 5, 2020, is \$197,300.

THE BASICS

Reasonable Compensation

There is no specific formula to set reasonable compensation for a health center executive, like the Chief Executive Officer (CEO). Typically, the “facts and circumstances” guide each decision. Consider the current rate of compensation paid to similarly qualified and experienced people performing similar functions for similar organizations in the community. It often helps to conduct a local salary comparability study.

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 if an executive or an applicant clearly merits higher compensation. Similarly, a center is not expected to cap pay at the high salary reported. Compensation practices of for-profit organizations can also be used in salary comparability studies. For example, salary paid to the Chief Financial Officer (CFO) of a similarly sized private medical group or clinic in the community could be used to establish a reasonable rate for a health center’s CFO. Or, an offer letter with a salary quote from a comparable organization to a prospective executive employee can be used. Under any circumstance, to be useful, comparable salary data must be current and describe salaries paid by organizations that are truly comparable to the health center.

There are several places to find salary comparability data. The National Association of Community Health Centers, Inc. (NACHC) annually publishes the Health Center Salary and Benefits Report for Health Centers to help with this process. Health centers can

otherwise commission a salary comparability study by a qualified compensation expert. IRS regulations offer that a center’s board of directors can rely on a written opinion from such an expert.

Generally, salary comparability studies serve as a benchmark to guide a health center’s compensation decisions. Factors such as an individual’s experience with the center, their contribution to the center’s mission, how hard it is to recruit a replacement, unique skills, and other factors should also be considered.

It is important to note that a center must document the reasons for its compensation decisions. As compensation approaches or exceeds the high-end of the “comparable” range, documentation requirements increase significantly.

Unreasonable Compensation

Executive compensation that exceeds the bounds of reasonable compensation will result in a “cost disallowance” if charged to a federal grant. This means that the amount considered to be “unreasonable” may not be charged as a cost under the grant. While this isn’t a problem if a health center can make up the difference with non-grant funds,³ the federal tax consequences can be significant.

As previously mentioned, private “inurement” is not permitted for an organization to obtain and retain federal income tax exemption. For this reason, paying unreasonably high compensation to key executives and other organizational “insiders” can result in the loss of an organization’s tax-exempt status. As a practical matter, that rarely happens. The IRS is reluctant to revoke an organization’s income

³ 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 deliver the scope of project described in the approved application. See Health Center Compliance Manual, Chapters 15 and 16 (August 2018).

tax exemption because that is likely to drive an organization out of business or deprive the community of charitable services.

INTERMEDIATE SANCTIONS

Before 1995, the IRS didn't clearly regulate the compensation practices of tax-exempt organizations. In 1995 Congress enacted Section 4958 of the IRC, also known as the "intermediate sanctions" provision. This legislation gave the IRS authority to impose tax penalties on certain individuals who receive unreasonably high compensation and those who knowingly approve the compensation. The Section 4958 tax penalties are targeted at key executives of the 501(c)(3) and board members, referred to as "disqualified persons" and "organization managers" in the statute.

The penalties are less extreme than the loss of an organization's tax-exempt status, but they can still be substantial. At a minimum, an individual who receives unreasonably high compensation described as an "excess benefit," must return the amount of the excess benefit, plus interest, to the organization. The individual can be liable for an excise tax in the amount of 25% of the excess benefit. The penalty increases to 200% if the excess benefit is not corrected within a reasonable amount of time (for example, returned with interest before the IRS issues a deficiency notice). Organization managers (see below) 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.

Disqualified Persons

It is extremely important for health centers to identify their disqualified persons under Section 4958. These are the people at risk for tax penalties if they receive an excess benefit. Most, if not all, health center executives are likely to be disqualified persons. Personnel automatically considered "disqualified" include:⁴

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

In addition, anyone in a position to exercise "substantial influence" over the affairs of a health center, regardless of their title, is a disqualified person. IRS regulations⁵ 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. For example, a center's Chief Medical Officer (CMO), depending on the local facts and circumstances. Or, individuals with authority to control a significant portion of the organization's capital expenditures, operating budget, or employee compensation, or with direct managerial authority or advising a person with managerial authority could be included. Note: being in the position to exercise substantial influence is the only thing required to be a disqualified person, even if the person did not exercise influence.⁶

There is a "safe harbor" for individuals who receive economic benefits (salary and taxable

4 Board members are automatically considered to be disqualified persons, but they are unlikely to face reasonable compensation issues since health centers do not typically compensate board members for their board service. However, board members who receive financial benefits from a center (i.e., substantial gifts or other "perks") could run afoul of Section 4958. Board members are also "organization managers" who could be liable for knowingly approving unreasonable compensation for executive staff.

5 The IRS regulations implementing Section 4958 are codified at 26 C.F.R. § 53.4958-0 through § 53.4958-7.

6 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.

benefits) of less than \$130,000.00 per year.⁷ 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

An organization manager who knowingly participates in an excess benefit transaction (i.e., payment of unreasonable compensation), is subject to pay a 10% tax on the excess benefit. Under the IRS regulations, an organization manager includes:

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

As a practical matter, health center board members and officers will always be treated as organization managers. They risk penalties if they knowingly and willfully approve an excess benefit transaction. An “officer” includes individuals designated to be an officer based on the articles of incorporation or bylaws, or individuals who regularly make administrative or policy decisions on behalf of the center. Similarly, a health center CEO qualifies as an organization manager since they regularly make administrative and policy decisions and typically hire and fire staff. A CEO may knowingly approve excessive compensation for an executive who is a disqualified person.

There are some protections for organization managers. A reasoned written opinion by an appropriately qualified professional (i.e., an attorney, CPA, independent valuation expert) can justify a compensation decision. In that case, the organization manager would not

be required to pay the penalty, even if the IRS finds that compensation was excessive. Similarly, the liability risk for all parties can be removed, generally, if the board follows the “rebuttable presumption” procedures for executive compensation. (Learn more about rebuttable presumption later in the document.)

Timing Issues

Identifying Disqualified Persons

Timing is important. A person is a disqualified person if he or she was in a position to influence an organization’s affairs (or was the CEO, CFO, COO, etc.) any time within the five-year period preceding a compensation transaction. For example, if a physician served as a health center’s CMO with sufficient influence until January 1, 2018, then returned to her position as a staff physician, her compensation is subject to Section 4958 standards until January 1, 2023.

Initial Contract Exception

Section 4958 does not apply to any fixed payment made to an executive under an initial contract, if they were not a disqualified person when the initial contract was signed. For example, a newly hired health center executive (such as a CEO) would not be subject to penalties under Section 4958 if they received “unreasonable” compensation as part of their initial contract. Board members would not be liable for approving the compensation.

The initial contract exception, also known as the “one bite” rule, applies only if there is a written employment contract, and only if the compensation is “fixed.” Fixed compensation refers to a specific amount of cash (and/or other non-cash compensation) stated in the contract or based on a clear (not discretionary) formula listed in the contract. For example, the initial contract may offer a fixed

⁷ For calendar 2020, this amount is \$130,000 and is subject to annual cost-of-living adjustments.

cost-of-living increase based on a particular consumer price index, or a percent increase tied to the center's net income.

The "one bite" rule applies when the terms of the initial contract do not change. On the other hand, if a newly hired CEO were awarded a substantial raise in the second year of a five-year employment contract (above the compensation stated 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 she received the raise, her 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 since the CFO was a disqualified person when he was promoted.

Note: the initial contract exception only removes the assessment of Section 4958 for tax penalties, but it does not eliminate the (unlikely) possibility that the IRS could question executive compensation as an impermissible private benefit. For this reason, health centers are always advised to conduct a reasonable compensation analysis when hiring and promoting executives.

Computing Total Compensation

When determining a reasonable compensation, all items of executive compensation provided by a health center must be taken into account. 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 non-salary benefits, whether or not they are included in gross income for income tax purposes.

All relevant benefits should be aggregated and reported as compensation for purposes of determining the "reasonableness" of the total compensation package paid to the executive.

Some benefits provided to executive staff may be subject to Section 4958 tax penalties if they are not reported as compensation on the employee's Form W-2 or on the health center's annual Form 990. For example, reimbursements paid to an executive as part of an "accountable plan" (i.e., per diem and travel reimbursement, mileage costs, etc. that are documented) are disregarded under Section 4958. However, expense reimbursements under arrangements that are not part of an accountable plan must be reported as compensation. Similar rules apply to the value of the private use of a health center's⁸ automobile and most other non-salary benefits. All must be reported as compensation or be treated as an "automatic 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

In some cases, an executive can earn a legal right to payment, or a "vested" right to receive compensation, based on past commitments, such as a promise to work for the center for a certain period of time. This is considered a "retention incentive."

⁸ 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 45 C.F.R. §75.431 (f).

For example, a CEO may be offered a \$50,000.00 “bonus” if they agree to stay with the health center for a full five-year employment contract. For Section 4958 considerations, 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 if the sum of the CEO’s actual compensation in a particular year plus the \$10,000.00 deemed compensation exceeded “reasonable compensation” in that year. The sum of excess benefits, if any, paid over the five-year contract period would be aggregated for purposes of Section 4958 penalties in the year that the bonus is paid.

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

The best way to avoid unpleasant income tax consequences when compensating health center executives is to make sure compensation is always “reasonable.” The tax law provides a “rebuttable presumption” to help. It offers prescribed steps that the board of directors should follow when 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 steps must be followed 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 obtain compensation information from three (3) similar organizations in the community or in similar communities);

- The comparability data must be current, 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);
 - The comparability data relied on and how it was obtained; and
 - If the board (or board committee) determines that compensation is higher than comparable data, it must document the reasons why the compensation is still reasonable under the circumstances.

Note: Though a health center board committee is permitted by the IRS to obtain and review compensation data, all personnel hiring decisions (and specific compensation offers) are typically delegated to the CEO. The board has the final responsibility to establish compensation schedules (i.e., ranges for particular categories of employees) for all health center staff.

INCENTIVE COMPENSATION

Tax Considerations

Health centers, like other tax-exempt organizations, may provide incentive compensation to executive staff to encourage and reward outstanding performance. As a tax-exempt

organization, private inurement is not allowed (i.e., unreasonably high compensation for health center “insiders,” such as executive staff). When deciding upon an executive incentive compensation plan, it is important to avoid unreasonably high compensation offers for disqualified persons. Unreasonably high compensation could result in tax sanctions.

The IRS wants tax-exempt organizations to consider the methodology they use for awarding incentive compensation. Incentive arrangements must promote the charitable purposes of a tax-exempt organization. For example, incentives for health center executives should be designed to enhance quality and/or expand services, reduce costs, increase patient satisfaction, etc. Incentives that are designed to simply produce more revenue without consideration for the organization’s charitable programs are not favored.

In particular, the IRS looks closely at so-called “revenue sharing transactions.” These are situations where a compensation arrangement, including incentives, is based (in whole or in part) on the revenue earned by a tax-exempt organization. Incentive compensation based on a percentage of collections is a classic example. Section 501(c)(3) says, in part, that “no part of the net earnings” of a tax-exempt organization may “inure” to the benefit of private parties. This means that the IRS — with support by the courts — does not allow compensation to be calculated in a manner that conveys an interest in the organization’s net earnings. For example, an executive’s incentive compensation cannot be based on a percent of a health center’s net income without regard to the executive’s individual contribution to the center’s mission. Instead, incentive compensation based on revenue

should be carefully structured to assure that it promotes the center’s charitable health care mission.

The IRS outlined the factors used to determine whether an incentive compensation arrangement constitutes private inurement or impermissible private benefit in its fiscal 2000 Continuing Professional Education (CPE) Technical Instruction Program.⁹ 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 here)?
3. Was there an “arm’s length” relationship between the organization and compensation recipients, or did the recipients unduly influence the incentive award?
4. Does the compensation arrangement include a reasonable maximum amount an employee may earn to protect against projection errors or substantial windfall benefits? (Note: The IRS regulations implementing Section 4958 specifically note that a “cap” is important to determine the reasonableness of compensation.)
5. Does the incentive program have the potential to reduce the charitable services or benefits an organization would otherwise provide by diverting resources to executive compensation?
6. Does the compensation arrangement take into account data measuring quality of care and patient satisfaction?

⁹ 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.

7. If the incentive arrangement depends on net revenues, does it also consider charitable goals, such as keeping expenses within budgeted amounts so that charges for services do not increase?
8. Does the arrangement transform the principal activity of the organization into a joint venture?
9. Is the arrangement designed to divert all or a portion of the organization's profits to people in control of the organization?
10. Does the compensation arrangement serve an actual and apparent business purpose of the exempt organization, such as to promote efficiency, as opposed to the purpose directly or indirectly benefitting the persons receiving incentive compensation?
11. Does the compensation arrangement cause unwarranted harm, for example if compensation increases are based 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 will not pass IRS scrutiny, the relative importance of other individual factors will be taken into account. The facts and circumstances of each particular case are important. Health centers should analyze their incentive compensation arrangements in light of all relevant factors.

Federal Grant Cost Principles

Incentive compensation linked to cost reductions, efficient performance, or some other discernible benefit to a grant-funded

program is allowed under the federal cost principles. Of course, the overall compensation paid, including the incentive, must be "reasonable."

The federal cost principles impose two other important requirements. Incentive compensation must be paid (or accrued) according to:

- An agreement established before services linked to the incentive were performed; or
- An established plan followed by the organization so consistently as to imply an agreement to make the payment.

In short, the federal cost principles require that an incentive compensation arrangement be established by contract (explicitly) or according to established policies and procedures (implicitly), before the services linked to the incentive payment is performed.

CONCLUSION

An effective compensation system helps the board with the recruitment and retention of a competent CEO, and helps the CEO with the recruitment and retention of the senior management team. In order to avoid potential income tax penalties and cost disallowances under federal grant awards, the compensation system must ensure that compensation is reasonable under the circumstances. To establish reasonable compensation, it's important to gather and utilize current comparability data. Documenting the reasons for a compensation arrangement is equally important.

The term **“health center”** refers to public or private nonprofit entities that: (1) receive grants under Section 330 of the Public Health Service Act (Section 330), including Sections 330(e), 330(f), 330(g) and 330(h) (collectively “Health Center Program Grantees”); and (2) entities that have been determined by the Department of Health and Human Services (DHHS) to meet the Section 330-Related Requirements to receive funding without actually receiving a grant (“health center look-alikes”).

The term **“Section 330-Related Requirements”** refers to requirements set forth in:

- Health Center Program Statute
- Program Regulations: [42 CFR Part 51c](#) and [42 CFR Parts 56.201-56.604](#)
- Health Center Program Compliance Manual: <https://bphc.hrsa.gov/programrequirements/compliancemanual/introduction.html>
- HRSA’s Federal Financial Assistance Conflict of Interest Policy

The term **“Grant Requirements”** refers to Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards: 2 CFR Part 200, as adopted by DHHS at 45 CFR Part 75.

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