VENABLE LLP

Special Report

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Tax-Exempt Healthcare Prepares for 2009:
Key Compensation and Reporting Points

Radical changes will affect tax-exempt healthcare organizations and their executives, directors and employees in several crucial, high-profile areas. These include executive and deferred compensation, pensions and IRS reporting. In this Special Report, Venable offers points based on our collective research, presentations and consultations conducted throughout the year. We trust they will enable busy executives to continue preparing for 2009 in terms of what needs to be accomplished and why.

I. Executive and Deferred Compensation

- **What you should do now**:
  - Set up 409A compliance policies and procedures now in order to be able to take advantage of any IRS correction program when you need it (and most employers will need it).
  - Look for the "desk-drawer" plans and agreements, and any other agreements that have been under the radar. These will need review for 409A compliance and may need to be reported on the Form 990.
  - Locate and review existing severance agreements and arrangements contingent on a non-compete. Expected tax rule changes will modify the tax consequences of many such arrangements. You might wish to advise affected individuals of those possible consequences (i.e., vesting and immediate taxation).

- **Why you should do it**:
  - Deferred compensation arrangements must be in compliance with 409A by December 31, 2008 – both in form and operation.
  - This includes all individual agreements (employment, retention, severance, etc.); agreements with independent contractors (i.e., physicians); and traditional deferred compensation plans.
  - Favorable transition rules are in effect only until December 31, 2008.

- Significant penalties fall on the individual for non-compliance (in form or operation): immediate taxation plus interest at a penalty rate plus a 20% additional tax.

- A limited correction program is available. To be able to use it, 409A compliance policies and procedures must already have been in place.

- New rules are expected before year end for tax-exempt executive compensation (457(f) arrangements).

  - These new rules are likely to cover severance arrangements (currently not treated as deferred compensation under 457).

  - They are also likely to treat payments that are contingent on a non-compete as fully vested and therefore subject to immediate taxation.

- Remember, the new Form 990 requires specific thorough reporting of all types of deferred compensation for listed individuals, and is subject to penalties of perjury. Kill two birds with one stone and do your 409A review at the same time.

II. Tax-Sheltered Annuities

- **What you should do now**:

  - Begin compliance efforts, including:

    - Preparation of a legally compliant written plan document that also includes appropriate defensive/protective language.

    - Review of internal recordkeeping and payroll systems to ensure ability to administer plan.

    - Review of service provider contracts for appropriate ongoing and additional services, and for appropriate risk allocations.

    - Location of former participants with outstanding contracts.

  - If subject to ERISA:

    - Engage an independent auditor now and begin information gathering for 2009 financial statement opening balance.

    - Budget for audit expenses.

  - Document "good faith" compliance efforts.

- **Why you should do it**:
  - Dramatically different rules for 403(b) plans become effective January 1, 2009. This is a paradigm shift – really.
    - Generally, 403(b) plans will be treated like 401(k) plans, and will be subject to many of the same kinds of rules.
    - Generally, the employer will be responsible for complying with and enforcing these rules.
    - This complete change in approach will require you to:
      - ◊ Coordinate and oversee annuity vendors; and
      - ◊ Oversee internal compliance with plan rules, i.e., participation rules, contribution limits.
  - 403(b) plans (subject to ERISA) also must file full Form 5500 annual reports, including audited financial statements beginning with 2009 plan year.
    - The first audit process may be difficult and expensive, as auditors will need to determine a beginning balance for the plan based upon previously unaudited plan years and record keepers will be updating systems for the Form 5500 changes.
    - Stricter auditing standards will require auditors to look for risk beyond the confines of the plan.
  - As a general matter, both DOL and IRS are actively investigating and enforcing fiduciary and filing requirements, including assessment of penalties.
    - The DOL assessed $1.5 billion as a result of 3,236 civil investigations during fiscal year 2007.
    - IRS has notified thousands of plan sponsors regarding late or missing Forms 5500, subject to potential penalties of up to $15,000 per form.
  - Participant litigation also continues to increase. For example, under LaRue v. DeWolff, Boberg & Associates, participants may now sue to recover individual losses due to fiduciary failures.

III. The New Form 990

- **What you should do now:**
  - Do a dry run on the new Form 990 now to see (i) if you will be able to answer all of the questions, and (ii) if you will be able to answer them in the way you would want to answer them.
    - Data Collection. Potential trouble spots include:
      - ◊ new Schedule H (facilities list for 2008; charity care for 2009);
      - ◊ new Schedule J (detailed compensation reporting for executives and other highly paid individuals);
      - ◊ new Schedule K (list of outstanding tax exempt bonds issued after 2002; additional information in 2009); and
      - ◊ new Schedule L (expanded reporting of transactions with "Interested Persons").
    - Internal Operations. Potential trouble spots include written policies and procedures for conflicts of interest, whistleblowers.
  - Remember, the Form is subject to public disclosure. Take this opportunity to pre-plan your presentation.
- **Why you should do it:**
  - The new Form 990 must be used for the 2008 fiscal year.
    - There is a "small entity" phase-in over three years, accomplished by raising the Form 990-EZ thresholds for the 3-year phase in period.
      - ◊ Organizations with gross receipts of less than $1 million and total assets less than $2.5 million may file the EZ for 2008.
      - ◊ This threshold is then lowered for 2009 and 2010. Beginning with the 2010 tax year, the Form 990-EZ thresholds will be permanently set at $200,000 in gross receipts and $500,000 in total assets.

- The new form is significantly different from the old form.
  - The Form is longer – an 11 page "Core Form," plus 16 Schedules, most of which will apply to hospitals, including:
    - ◊ Schedule H for hospitals (phased in)
    - ◊ Schedule J for detailed executive compensation reporting, and
    - ◊ Schedule K for tax-exempt bonds (phased in).
- The new Form requires reporting of significantly more data than ever before, much of which relates to questions not previously asked, including:
  - New data about endowment funds, state registration for fundraising, and fund-raising events;
  - More detailed information on financial operations (including compensation paid to top employees and the organization's endowment, if any);
  - Information about governance (including procedures for setting compensation); and
  - Information about internal controls (including conflict of interest, whistleblower, and document retention policies).
- The revised instructions for the Form and the Schedules, issued August 19, 2008, are over one hundred pages long. Familiar terms have new definitions and there are many new terms. It will take a significant amount of time to review these instructions and analyze their impact on your particular situation.

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