



# Executive Compensation in Not-for-Profit Health Systems

## Context, Constraints, and Misconceptions

Executive compensation has always been a hot topic and one that is frequently scrutinized by regulators, media, employees, and the public alike. For not-for-profit health systems, the circumstances under which they operate are very complex and nuanced – especially given the magnitude of their charitable activities.

They are often among the largest employers in cities, states, and even the nation. They run 24/7 health care delivery services, conduct research into the treatment and cure of diseases, and educate future clinicians. The complexity, size and scale of many not-for-profit health systems can be immense and executive compensation amounts can be misinterpreted by third parties if not viewed through the proper context.

Understanding how executive compensation is determined, governed, and structured within these systems reveals a more nuanced reality than what is often depicted in media outlets. To fully appreciate that reality, it is important to consider the unique governance, regulatory, and reporting requirements under which not-for-profit health systems operate, as well as the ways in which they differ from their for-profit counterparts.

Not-for-profit health systems are constrained by their tax-exempt status and state not-for-profit corporation laws in the types of compensation they may offer. As a result, executive compensation is subject to a well-established framework of regulatory requirements and oversight. Unlike their for-profit counterparts, not-for-profit health systems cannot offer stock or equity, which provide greater financial upside and more tax-efficient vehicles for compensation.

## How Compensation is Regulated and Enforced

Not-for-profit health systems operate under two distinct regulatory structures, both of which provide that only “reasonable” compensation may be paid, and that the board (or designated committee of the board) is bound by a duty of loyalty to approve only that compensation determined to be reasonable:

**State-Level:** Governed by state not-for-profit corporation law and subject to oversight by the state attorney general and charitable trust regulators

**Federal-Level:** Subject to IRS regulation and compliance requirements tied to tax-exempt status under the Internal Revenue Code

Two core principles define not-for-profit operations:

**Mission Limitation:** Corporate activities are restricted to those authorized by state law and defined in the Articles of Incorporation

**Non-Distribution Constraint:** Profits must be reinvested into the organization’s charitable purpose rather than distributed to shareholders or individuals

## How Compensation is Determined

Executive compensation decisions are not made unilaterally – they are governed by independent boards with fiduciary responsibilities and controlled by a majority of independent directors. The board, or an authorized committee of the board such as the compensation committee, usually performs these duties and is staffed with directors who have the right skills and experience to carry them out.

Decision-making is typically supported by staff members, legal counsel, and outside consultants to ensure a robust governance process compliant with regulations on executive compensation reasonableness. These boards and compensation committees are legally required to act in the best interests of the organization’s charitable mission – not private interests.

Compensation for senior executives is typically determined by following a three-step process outlined by the IRS to establish a rebuttable presumption of reasonableness:

1. **Independent Approval Body:** Decisions are made by board members who are free from conflicts of interest with respect to the compensation arrangements being reviewed.

2. **Comparable Market Data:** The approving body obtains and relies on compensation data from independent sources for functionally comparable positions at similarly situated organizations.
3. **Documentation:** All decisions, supporting data, and rationale are formally documented.

If this process is followed, the burden shifts to the IRS to disprove the board's determination of reasonableness. Organizations that fail to meet these standards may risk losing their tax-exempt status or incurring excise tax penalties.

## How Compensation is Structured

Not-for-profit and for-profit health systems operate under fundamentally different executive compensation frameworks with meaningful distinctions in compensation vehicles, incentive structures, taxation, and more.

- **Equity-Based Compensation:** Not-for-profits are prohibited from offering equity-based compensation such as stock options or restricted shares. In for-profit settings, equity can represent a significant portion of executive total compensation.
- **Incentive Compensation:** Not-for-profit executive incentive plans are capped and typically represent a smaller percentage of compensation than for-profit plans. For-profit executive incentives tied to equity are effectively uncapped as they are aligned with stock price and the creation of shareholder value.
- **Tax Treatment:** Not-for-profit executive compensation is paid primarily as salary and cash incentives that are taxed as ordinary income at federal rates of up to 37%. State and local income taxes on ordinary income are then also paid in most states – plus 2.35% of employee Medicare taxes on high wages. In for-profit settings, a significant portion of compensation may be delivered as equity. While taxed at grant-date value, it can be worth significantly more with the upside opportunity taxed at lower capital gains rates.
- **Deferred Compensation/Supplemental Retirement Plans:** Not-for-profit executives pay taxes on supplemental retirement plan balances when they vest, even if not yet paid out. For-profit executives pay taxes only when funds are actually distributed. In the absence of equity, not-for-profits have historically used supplemental executive retirement plans (SERPs) as a retention tool. These plans deliver less value, carry less favorable tax treatment, and are subject to creditor claims in the event of bankruptcy.

- **Organizational Tax Obligation:** Under IRC Section 4960, not-for-profit health systems pay a 21% excise tax on executive compensation exceeding \$1 million per covered employee. This tax is paid by the organization. While for-profit companies may lose a tax deduction on compensation above \$1 million, they do not face a direct excise tax.

## How Performance is Measured

Not-for-profit CEO incentive compensation is often tied to a board-approved performance scorecard that supports the mission and goes beyond financial goals.

Metrics typically include:

- Clinical Quality and patient safety
- Patient experience
- Access to care
- Workforce engagement
- Financial sustainability

This differs from publicly traded companies, where a significant portion of executive compensation is often determined by economic value creation and stock price performance.

## How Compensation is Disclosed: Form 990

For not-for-profit health systems, executive compensation is publicly reported on IRS Form 990.

Several structural aspects of this report can affect how the numbers are interpreted:

- **Double-Counting:** Deferred compensation and retirement benefits may be reported when earned and again when paid, which can make compensation appear higher in certain years than it actually is in practice. For instance, if a \$100,000 award is earned equally over a 5-year period, an accrual of \$20,000 will be reported each year, and a final payment of \$100,000 will be reported when paid out after 5 years.
- **Lack of Context:** Unlike SEC proxy statements, which include a Compensation Discussion and Analysis, Form 990 is a tax reporting document and does not pair compensation figures with an explanation or with the full context of the community benefit provided by not-for-profits. Executive pay appears on Schedule J while community benefit data – such as charity care and Medicaid shortfalls – appears on Schedule H.

## Conclusion

Context is key when examining executive pay levels in not-for-profit health systems. It's important to consider timing, structure, tax treatment, and mission – not just the headline figures.

Not-for-profit health systems operate under strict regulatory oversight, a high level of stakeholder accountability, and more limited compensation tools than their for-profit counterparts. At the same time, they face equal demands in terms of governance, scale, complexity, and impact. Their stakeholders are the communities, patients, and families they serve, not financial investors. Margin is reinvested into patient care, facilities, and community benefit

And not-for-profit health systems do not sit outside of the tax system – they just generate tax revenue differently: through ordinary-income taxation of compensation, through the Section 4960 excise tax, and through one of the largest payroll and employment footprints in the American economy.

The key question is whether the compensation structure supports high-performing, stable leadership capable of improving the affordability of health care, sustaining access to care, improving quality/clinical outcomes, and serving communities effectively over the long term in a manner consistent with the mission and obligations of a charitable organization.

## Partnering with SullivanCotter

SullivanCotter partners with health care organizations to develop executive compensation strategies that align with organizational goals, support regulatory compliance, strengthen governance processes and ensure pay programs remain competitive, defensible and mission-focused in an increasingly complex health care environment.

**Reach out to learn more:**

[sullivancotter.com](https://sullivancotter.com)

[info@sullivancotter.com](mailto:info@sullivancotter.com)

888.739.7039

