I. REASONABLE COMPENSATION

by

Jean Wright and Jay H. Rotz

1. Introduction

When The Washington Post reported on February 28, 1992 that United Way President William Aramony's annual compensation package totalled $463,000, there was an outcry that the amount was excessive for the president of a tax exempt organization. Similar questions have been raised about executives of other nonprofits, particularly health care organizations. The controversy reflects the public's fears that no one is watching the expenditure of dollars to assure they are going for the purposes for which they are intended. In a taxable public corporation, investors want the highest return for their dollars and thus have at least a theoretical incentive to scrutinize expenses closely.

In closely held corporations, the possibility that the Service might recharacterize excessive compensation as a dividend (which is non-deductible, of course) operates as a deterrent. But in a tax exempt organization, neither of these checks exists. Instead, the public must rely on often inadequate oversight by volunteer boards of directors, the occasional media inquiry (as in the United Way situation), some activist state attorneys general, and the vague threat that the Service might question the compensation to encourage proper use of charitable donations.

While the possibility that the Service will deny or revoke exempt status because of excessive compensation is certainly real, as shown by numerous cases discussed in this article, this possibility is often more properly used as a tool to persuade exempt organizations' boards of directors to tighten their oversight and control of compensation.

This article provides guidance to Service personnel evaluating organizations' compensation arrangements. It defines reasonable compensation, and explains how compensation can result in inurement, private benefit, self-dealing, or violations of other sections of the Code. Further, the article identifies the many factors involved in deciding whether compensation is reasonable. These include factors relating to the employee, the organization, and the compensation itself. The article gives examples of situations where the Service and the courts have found reasonable or unreasonable compensation, and offers sources of information on comparable salaries for use when examining the reasonableness of compensation paid by exempt organizations.

2. Overview of the Reasonableness Test

A. Permissibility of Compensation Generally

An important early compensation case involving exempt organizations was Mabee Petroleum Corp. v. U.S., 203 F.2d 872 (5th Cir. 1953). In that case, the Fifth Circuit Court of Appeals established the important principle that the payment of reasonable salaries to corporate officers does not create inurement. While many people do donate services to exempt organizations as directors or even in more subordinate roles, the law does not require it. The Tax Court has stated that, "[t]he law places no duty on individuals operating charitable organizations to donate their services; they are entitled to reasonable compensation for their efforts."

Other cases reiterating this principle are World Family Corporation v. Commissioner, 81 T.C. 958 (1983); Saint Germain Foundation v. Commissioner, 26 T.C. 648, 658-59 (1956); Broadway Theatre League of Lynchburg, Va. v. U.S., 293 F. Supp. 346 (W.D. Va. 1968); Ecclesiastical Order of the ISM of AM v. Commissioner, 80 T.C. 833 (1983); People of God Community v. Commissioner, 75 T.C. 127, 131 (1980); and B.H.W. Anesthesia Foundation, Inc. v. Commissioner, 72 T.C. 681 (1979).

B. Reasonableness Requirement

1. Origins

The concept of a reasonableness requirement is present in the earliest exempt organization compensation cases, such as Home Oil Mill v. Willingham, 68 F. Supp. 525 (D.C. Ala. 1945), aff'd, 181 F. 2d 9 (5th Cir. 1950), cert. den., 340 U.S. 852; and Mabee, supra. Those cases are not based on any statutory provision, but more generally on principles of state trust law.

A statutory basis for the reasonableness requirement has been developed based on IRC 162, which imposes a reasonableness requirement for deductibility of compensation as a business expense. In Enterprise Railway Equipment Company v. U.S., 161 F. Supp. 590 (Ct.Cl. 1958), the Court of Claims applied the reasoning of IRC 162 to exempt organizations. Because many more cases have been decided under IRC 162 than IRC 501, that section offers valuable guidance for deciding compensation cases.

2. General Rule

Reasonable compensation is defined by Reg. 1.162-7(b)(3) as the amount that would ordinarily be paid for like services by like organizations in like circumstances. Thus, the concept has two prongs: 1) an amount test, focusing on the reasonableness of the total amount paid; and 2) a purpose test, examining the services for which the compensation was paid. These two prongs are not separate issues, focusing on different facts. Rather, the various factors in a particular situation taken together determine whether either or both of the tests is satisfied.

For example, assume that the president and founder of an IRC 501(c)(3) private foundation receives a $40,000 annual salary from the foundation. There was no arm's length bargaining to determine the salary. The president works approximately 40 hours per week, and has extensive administrative and managerial duties. All of these facts will be part of an analysis of whether the amount paid is reasonable and whether it was paid to enable the organization to carry out its exempt purposes.

Numerous courts have held that reasonableness is a question of fact "...to be resolved ...under all the existing circumstances." E.g., Home Oil Mill v. Willingham, supra and Mabee, supra. Therefore, reasonableness cannot be determined in advance and is a question best decided on examination.

The Service may issue an advance ruling on whether a compensation plan is inconsistent with exempt status as a device to distribute profits to principals or create a joint venture, or on whether a plan was the result of arm's length bargaining (both arguments are discussed below), but it will not give an advance ruling on reasonableness. Rev. Proc. 92-3, 1992-1 I.R.B. 55 (Sec. 3.08). See also G.C.M. 39674 (October 23, 1987). Presumably, this rule is predicated on the theory that reasonableness of compensation in any particular instance is too inherently factual to be determinable in advance.

C. Types of Compensation Included

When evaluating an exempt organization's employees' compensation, all forms of compensation paid must be included in the analysis. For the purposes of this discussion, the term "compensation" includes at least the following: 1) salary or wages; 2) contributions to pension and profit sharing plans; 3) unpaid deferred compensation; 4) payment of personal expenses; 5) rents, royalties or fees; 6)

personal use of organization's property or facilities. A 1990 CPE article (p. 171) discusses at length the many different forms compensation may take.

In an exempt organization audit, it is important to look for compensation in a form other than salary or wages, since many inurement situations typically involve payments in some form other than salary. For example, in Church of the Transfiguring Spirit v. Commissioner, 76 T.C. 1 (1981), the court found that a housing allowance was unreasonable.

Form 990, Part V, asks for information about hours worked, compensation, contributions to employee benefit plans, and expense accounts and other allowances for officers and directors. Schedule A of the Form 990 asks for the same information for the five highest paid employees and for any person paid more than $30,000 for professional services. If an organization fails to disclose fully the information requested on the Form 990, the organization could be liable for penalties, regardless of whether the total compensation paid is reasonable.

3. Tax Issues Raised by Compensation

A. Inurement

1. Proscription Against Inurement

IRC 501(c)(3) prohibits inurement of the net income of an organization to any private shareholder or individual. Reg. 1.501(c)(3)-1(c)(2) states that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private individuals.

Reg. 1.501(a)-1(c) provides the definition of "private shareholder or individual." That section states that the words refer to persons "having a personal and private interest in the activities of the organization."

2. The Required Insider Relationship

Inurement is most likely to arise when an "insider" relationship exists between the person benefitted and the organization. Generally, an organization's officers, directors, founders and their families are considered insiders. The 1990 CPE contains an excellent discussion of inurement generally and the insider requirement specifically at pages 23-27. The cases discussed below in which courts or the Service

have found inurement provide some examples of the necessary insider relationship in compensation situations.

There is some controversy as to whether persons who are employees of an organization but have no other relationship with it are insiders. The Service takes the position that employees or other individuals who have a "close professional working relationship" with the organization with which they are affiliated have a personal and private interest in the organization sufficient to make them subject to the inurement proscription, even if they were recruited under arm's length contracts and are not directors, officers or otherwise in control of the organization. See G.C.M.s 39498 (April 24, 1986) (physicians); and 39670 (October 14, 1987) (college athletic coaches).

Because of the closeness of the employer/employee relationship, G.C.M. 38394 (June 2, 1980) recommends that compensation for controlling employees of a medical organization be established by an independent compensation committee to help eliminate the potential for abuse inherent when those controlling an organization set their own compensation.

The Tax Court does not appear to have accepted the Service's view that employees necessarily have a close enough relationship to an exempt organization to create an insider relationship for inurement purposes. In Senior Citizens of Missouri, Inc. v. Commissioner, 56 T.C.M. (CCH) 480 (1988), the Tax Court used a private benefit rationale to deny exemption to an organization which paid excessive commissions to its employees. The court rejected the Service's inurement analysis in the case.

3. Inurement From Compensation

The courts and the Service have found that compensation resulted in inurement in a number of cases. In Mabee, supra, the Fifth Circuit Court of Appeals ruled that excessive and unreasonable salaries create inurement. There, a former oil company executive continued to receive the $100,000 annual salary he had earned as president of the oil company even after he had formed a charitable trust and transferred the stock in the oil company to the trust. "...[P]urported salary payments were not intended merely to compensate him for services to be rendered, but were really authorized to assure him substantial distributions in the form of salary." Mabee at 616.

Birmingham Business College v. Commissioner, 276 F.2d 476 (1960) concerned a college that paid compensation according to a ratable distribution based on stock ownership. Because the college used this formula rather than paying a reasonable amount for services rendered, the court found inurement.

In Bubbling Well Church of Universal Love, Inc. v. Commissioner, 74 T.C. 531 (1980), the Tax Court found inurement from a church to its founders and their son, who were the church's only employees. The church received $61,170 in income, and almost all of it was spent for the family members' "living allowances", parsonage allowance, medical expenses, travel and other items. The church could not describe the expenditures in detail or explain how they furthered exempt purposes.

In Rev. Rul. 69-383, 1969-2 C.B. 113, the Service held that a hospital's contract with a radiologist to pay him a percentage of the gross receipts of the radiology department did not result in inurement. The agreement had been negotiated on an arm's length basis, the radiologist did not control the hospital but was instead merely an employee, the amount received under the contract was reasonable in terms of the responsibilities and duties assumed, and the amount received under the contract was not excessive when compared to the amounts received by other radiologists in comparable circumstances. See also G.C.M. 39670, supra.

Other examples of cases in which excessive compensation was held to create inurement are Harding Hospital, Inc. v. U.S., 505 F.2d 1968 (6th Cir. 1974) (doctors paid to supervise hospital organized by them and treating their patients); Birmingham Business College, Inc. v. Commissioner, supra (college's founder and two sisters); Texas Trade School v. Commissioner, 30 T.C. 642 (1958), aff'd 272 F.2d 168 (5th Cir. 1959) (payments to school's founder serving as president).

4. Reasonableness as Part of the Overall Review of Compensation

Organizations have attempted to argue in several cases that if compensation is reasonable, it should not be considered to create inurement, regardless of any other factors. The Service disagreed with this position in G.C.M. 37180 (June 24, 1977). There, a hospital maintained a plan under which employees who were physicians were allowed to defer specified amounts of their compensation until retirement or termination. The total amount of compensation paid was reasonable, and had been negotiated at arm's length. The Service focused on the fact that the deferred amounts remained the property of the hospital, and yet accumulated interest to be paid ultimately to the physicians, thus allowing what were clearly the earnings of the hospital to inure to the doctors. The Service expressly rejected the hospital's focus on

reasonableness. See also G.C.M. 35865 (June 21, 1974) (profit sharing plan held to create per se inurement).

Recently, the Service has repudiated this per se analysis in favor of a three-pronged test for analyzing inurement, in which reasonableness is just one part of the inquiry. The Office of Chief Counsel articulated the test in G.C.M. 39670, supra, based on a reading of Rev. Rul. 69-383, supra, and the other cases and rulings in the area.

The G.C.M. concerns an organization that pays deferred compensation, bonuses and various benefits to college athletic coaches to supplement their salaries. It states:

> ...[W]e currently believe that, with respect to any compensation package, it is necessary to examine the entire compensation package (including current and deferred amounts) and determine 1) whether that compensation package is not merely a device to distribute profits to principals or transform the organization's principal activity into a joint venture, 2) whether the package is the result of arms-length bargaining and 3) whether the compensation constitutes reasonable compensation.

See also G.C.M. 39674, supra (mere establishment of "profit-sharing" incentive plans does not result in inurement if the plan otherwise satisfies the three-pronged test).

Even reasonable compensation may still create inurement if it fails to meet one of the other prongs of the test. For example, in Founding Church of Scientology v. U.S., 412 F.2d 1197, 1202 (Ct. Cl. 1969), cert. den., 397 U.S. 1009 (1970), the court rejected the organization's defense of reasonableness, stating that:

> If in fact a loan or other payment in addition to salary is a disguised distribution or benefit from the net earnings, the character of the payment is not changed by the fact that the recipient's salary, if increased by the amount of the distribution or benefit, would still have been reasonable.

See also Gemological Institute of America v. Commissioner, 17 T.C. 1604, 1609-10 (1952) (distribution of one-half of an organization's net earnings to the founder was inurement even if the total amount paid to the founder was reasonable considering his ability and past services); People of God Community v. Commissioner, supra at 132 (net earnings of religious organization inured to benefit of ministers paid percentages of the gross tithes and offerings received).

B. Private Benefit

Although many of the cases on inurement from unreasonable compensation state that compensation raises private benefit as well as inurement issues, the cases are usually decided on the basis of inurement alone. For example, the Tax Court in People of God, supra at 131, noted that, "While not necessarily identical, the prohibitions against private inurement and private purposes overlap to a great extent...we will confine our discussion herein to the private inurement issue."

This preference for an inurement analysis over the private benefit rationale is probably due to the more abundant case law on inurement. Also, as noted below, all of the compensation cases in which the compensation has been determined by courts to be unreasonable involve deals which were not negotiated at arm's length. In those situations, the necessary "insider" relationship was present, making the private benefit analysis unnecessary.

Private benefit might be a good approach in cases where the entire compensation structure of an organization provides for excessive compensation. For example, some compensation arrangements might result in so small a proportion of an organization's resources going to direct, program-related expenses that it appears the organization's real purpose is simply employment for its staff.

The Tax Court made this type of argument in Senior Citizens of Missouri, Inc., supra, where an organization paid over 30% of its gross receipts in advances for work that was never shown to have been performed. The people to whom the money was paid were not related to the founder. The court found the amount paid to be substantial, particularly in light of the fact that only 8% of the organization's gross revenues went to fund its program-related activities. The court used a private benefit rationale rather than the inurement argument made by the Service in the case.

A U.S. district court affirmed an earlier Tax Court decision accepting a similar argument in a case in which three ministers of a church and their family were paid

excessive salaries. Church by Mail v. U.S., 48 T.C.M. 471 (1984); aff'd, 765 F.2d 1387 (D.C.D.C. 1985). However, the court also found inurement in that case, so it is unclear whether the private benefit argument would have succeeded if the facts necessary for the inurement finding had not been present.

C. Self-dealing

IRC 4941 provides that payment of compensation to a disqualified person is an act of self-dealing, unless the compensation for services is reasonable and necessary to carry out the exempt purpose of the private foundation, and is not excessive. Reg. 53.4941(d)-3(c) states that excessive compensation is determined under Reg. 1.162-7. The portion of the compensation determined to be excessive is the portion subject to tax.

An example of a compensation case involving self-dealing is Kermit Fischer Foundation v. Commissioner, 59 T.C.M. 898 (CCH) (1990). There, a foundation's sole trustee received compensation from the foundation irregularly, and the amounts appeared to be related more to his need for funds than to his duties and responsibilities. The Service offered uncontradicted expert testimony as to the normal compensation paid for trusts of the foundation's size. The expert suggested that a normal salary for a comparable trust would have been $1,450 to $2,000 per year, rather than the approximately $40,000 per year the trustee received during the years at issue.

Examples of situations in which there was not self-dealing from compensation can be found in G.C.M. 39547 (March 26, 1986) (payment by a private foundation to a trust company for services rendered as trustee was reasonable and did not constitute an act of self-dealing); and G.C.M. 39960 (January 16, 1987) (payment by a foundation to a disqualified person for investment advice was not self-dealing because the payment was reasonable and necessary to carry out the exempt purposes of the foundation and it was not excessive).

D. IRC 503(c)

Payment of unreasonable compensation is one of the "prohibited transactions" listed in IRC 503(c), which will result in loss of exemption. This section only applies to IRC 501(c)(17) and IRC 501(c)(18) organizations, and to certain IRC 401(a) organizations.

4. Factors in Judging Reasonableness

A. Overview

The Internal Revenue Manual section 4233.27 lists twelve factors to be considered by an agent on examination in IRC 162 reasonable compensation cases, while various courts have developed their own lists. The factors the Manual lists are:

1) the nature of the employee's duties;
2) the employee's background and experience;
3) the employee's knowledge of the business;
4) the size of the business;
5) the employee's contribution to the profit making;
6) the time devoted by the employee to the business;
7) the economic conditions in general and locally;
8) the character and amount of responsibility of the employee;
9) the time of year when compensation is determined;
10) the relationship of shareholder-officer's compensation to stock holdings;
11) whether alleged compensation is in reality, in whole or in part, payment for a business or assets acquired; and
12) the amount paid by similar size businesses in the same area to equally qualified employees for similar services.

Rather than track the listing in the Manual for IRC 162, the following discussion focuses on factors discussed by the Service or courts specifically in exempt organization cases. Where IRC 162 cases illustrate an important point not otherwise covered by an exempt organization case, they will be discussed. Also, this article groups together the factors dealing with the employee, the organization and the compensation itself.

B. Factors Relating to the Employee

1. Arm's Length Relationship

One of the most important factors in evaluating the reasonableness of compensation is whether the employer and employee negotiated the compensation at arm's length. Negotiations may be viewed either as an indication of reasonableness or as one part of a three-pronged inurement analysis. Most cases and rulings simply list arm's length negotiations as one factor in judging reasonableness. G.C.M. 39670, supra, expresses an alternative view that negotiations, reasonableness and whether an

arrangement is simply a device to distribute profits are three equal parts of an inurement analysis. Under either approach, arm's length negotiations are critical.

As one commentator has stated,

> Virtually all challenges by IRS to the deductibility of compensation have occurred in the context of salary arrangements between related parties... There does not appear to be any case which holds that compensation paid in a truly arm's length situation was unreasonable...In this situation, the operation of the normal system of commercial checks and balances is probably adequate to ensure a proper result so that review by the IRS is generally unnecessary."

Kafka, 390-2nd T.M., Reasonable Compensation at A-5.

However, it is important to note that while lack of arm's length bargaining is an important factor, it does not always create inurement. The Tax Court considered and rejected the notion that a salary that would be reasonable if paid to an unrelated third party becomes unreasonable if paid to a person having a personal and private interest in the organization. In World Family Corporation v. Commissioner, supra at 969, the court stated that, "Although in some circumstances such a finding may be warranted, it is clear that payment to an interested individual does not make a commission unreasonable as a matter of law."

In The Church of the Visible Intelligence that Governs the Universe v. U.S., 4 Cl.Ct. 55 (Ct.Cl. 1983), the Service argued that because the organization's bylaws allowed its founder to completely dominate the organization, there was an inference that the organization was operated for his benefit. The Claims Court agreed that this structure "raise[d] concern about the potential for abuse unless allayed by other information in the record." Supra. at 62. However, the court found no evidence to support the inference of improper private benefit or inurement because the founder had contributed money without receiving any benefit in return. He did not actually exercise his totalitarian powers.

2. Control By a Family or Founder

Domination by one family is often a factor in cases involving excessive compensation. For example, the court in Bubbling Well Church, supra at 534-5 noted that complete domination of a church by its founders and their son provided "an obvious opportunity for abuse of the claimed tax-exempt status." There, the parents and son were all employed by the church and they served as the only directors. In

Mabee, supra, the founder and sole contributor to the foundation served as its president and received a $100,000 salary, which the court found to be unreasonable.

Similarly, the dominant figure in the Church of Scientology and his wife were two of the three members of the board of trustees. The court cited this fact in its finding of inurement in Founding Church of Scientology v. U.S., supra at 1201.

However, domination by one person or family, while it raises concerns about potential abuse, does not necessarily prove it. In The Church of the Visible Intelligence that Governs the Universe v. U.S., supra, the Service had argued that the organization's complete control by its founder and head should disqualify it from exemption. The court rejected speculation about what the organization might do in the future in light of evidence that no abuses had occurred as of the trial, the organization's articles prohibited inurement, and it represented that the salaries paid to any workers it might hire in the future would be reasonable. The court refused to speculate about whether future pay limits would be reasonable.

3. Availability of Comparable Services From a Third Party

If the employer could have obtained comparable services at a lower rate from someone other than the employee in question, the rate paid the employee may be unreasonable. This factor often is closely related to a lack of arm's length dealing. In Mabee, supra at 616, the Court of Appeals stated, "We think it doubtful whether comparable services would have cost as much had they been acquired in an arm's length transaction from an outside source."

A district court applied the same type of analysis to deny exemption to an organization that paid its two part-time ministers excessive salaries.

> ...[W]e believe that services comparable to those performed by the ministers could be obtained from an outside source in an arm's length transaction at a more reasonable cost...It seems likely that a member of the clergy could be hired to perform the part-time duties for which the ministers are responsible at a salary of considerably less than $160,000 per year.

Church by Mail, supra.

While the court in Church by Mail did not need to see evidence from other churches to know that $160,000 a year in 1985 for 60% of a minister's time was

unreasonable, most situations will require outside evidence of comparable salaries to establish this factor.

4. Nature of the Employee's Duties

The employee's duties are an important factor in reasonableness. If the employee performs highly specialized and skilled tasks, has responsibility for a large volume of work, or supervises other employees, he or she may command a higher salary. For example, in Rev. Rul. 69-383, supra, concerning a hospital radiologist, the Service compared the radiologist's compensation with amounts received by other radiologists with similar responsibilities and handling a comparable patient volume at other hospitals.

5. Employee's Background and Experience

If an employee is particularly well-qualified for a position because of relevant prior experience, education, or proven expertise in the area, a higher salary might be warranted than would otherwise be the case. In Home Oil Mill, supra, a federal district court upheld a charitable trust's payment of $15,000 per year in salary to the chair of the trustees. The will creating the trust named the testator's sister as the chair. The Service had argued that the payment was merely a stipend for the testator's sister, rather than payment for services.

In finding the payment reasonable, the court emphasized that the testator had carefully instructed the trustee regarding the character, extent, problems and policies of the businesses included in the trust corpus, and had explained his charitable plans to her. She therefore had the necessary background to carry out his specific wishes. Also, the will specified that if the sister needed to call on the other trustees for services, their compensation was to be taken out of the $15,000 total for trustee compensation. Finally, the court found that $15,000 was a reasonable amount of compensation to pay anyone "...for a discharge of the duties and responsibilities inherent in the actual management of an estate of this size and character." Id. at 640.

6. Employee's Salary History

Although this factor does not appear to have been discussed in an exempt organization compensation case, it is a common theme in IRC 162 cases. For example, in Lefkowitz v. Commissioner, 46 T.C.M. (CCH) 485, 490-91 (1983), the court noted that the employee's salary increased substantially over salaries in his previous positions after he became the sole shareholder of the corporation, indicating

that his salary reflected his new influence rather than any new duties or capabilities. See also, Pacific Grains, Inc. v. Commissioner, 399 F.2d 603,607 (9th Cir. 1968); Kipnis v. Commissioner, 44 T.C.M. (CCH) 849 (1982).

However, where an employee has received inadequate compensation in previous years, as could well be the case with an employee who has worked for tax-exempt (and historically low-paying) organizations, a large increase over salaries received in previous positions may be reasonable. E.g., Medina v. Commissioner, 46 T.C.M. (CCH) 76 (1983).

The argument was rejected by a court due to a lack of evidence in one exempt organization case, Northern Illinois College of Optometry v. Commissioner, 2 TCM (CCH) 664 (1943), which involved a college of optometry run by one family. The salaries of all the family members combined rose from $25,850 in 1935 to $125,000 in 1938. The organization argued that the increase in salaries was due to its desire to increase the salaries of employees who had been underpaid over some time. The court stated that there was nothing in the record to show the employees had been underpaid.

7. Employee's Contribution to the Organization's Success

Exempt organizations have not traditionally evaluated their employees on the basis of the "bottom line" of financial success as do for-profit companies. However, when an organization is challenged for paying large salaries, one of the major arguments it may make is that the employee helps the organization raise a lot of money, or contributes to its success in some other important way.[1]

The Service tends to focus on the employee's contribution to the organization's accomplishment of its exempt purposes. In G.C.M. 39498 (April 24, 1986), the Office of Chief Counsel emphasized the need to evaluate the worth of a particular physician to a hospital to justify offering a particular package of recruitment incentives to that physician. The incentives cannot be justified on the basis of a

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[1] Some defended William Aramony's $463,000 salary from United Way on this ground. However, while United Way's contributions did increase over 17% beyond inflation during the past two decades, total national income over the same period rose over 60%, and overall charitable giving rose slightly more. Therefore, United Way "lost market share" during Aramony's tenure. Editorial, Washington Post, February 20, 1992 at A-24.

general need for qualified physicians; according to the G.C.M., the public benefit of the incentives must be evaluated for each physician.

8. Time Devoted to Job

Where an employee has more than one job or works part-time for an organization, the salary paid should reflect a decreased workload. In Mabee Petroleum Corp. v. U.S., supra at 616, the Court of Appeals emphasized the fact that the foundation's president devoted only part of his time to the foundation, and continued to work some with at least six or seven other large organizations. Similarly, in Church by Mail, supra, the two ministers devoted only 60% of their time to the organization, and yet received over $160,000 in compensation, a figure the court found unreasonable under the circumstances.

B. Factors Relating to the Organization

Just as important as the qualifications and work of the particular employee are the characteristics of the employing organization.

1. Salary Scale of Others in the Same Line of Business

Reg. 1.162-7(b)(3) states that, "[i]t is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances." IRC 162 cases often focus on the "like industries" aspect of the regulation because comparability of salaries in an industry is arguably a more objective factor in judging reasonableness than some others. Rutter v. Commissioner, 853 F.2d 1267 (5th Cir. 1988).

The tasks involved in two positions must be truly comparable before the salaries can be compared. For example, in Northern Illinois College of Optometry v. Commissioner, supra at 673, the court rejected evidence about the salary of a practicing optometrist to determine reasonableness of salaries since the employees in question were teaching optometry, not practicing.

2. Size of the Organization

A larger organization may pay a higher salary to its employees in reflection of the greater number and difficulty of tasks involved in its work. In Home Oil Mill, supra, the Tax Court found that $15,000 was a reasonable salary in 1945 for managing several large businesses as part of a charitable trust.

3. Salary Scale for Employees Generally

If the compensation to certain employees is generous, the salary to all probably should be, also. Disproportionate salaries to certain persons may indicate inurement or private benefit. Illustrative IRC 162 cases on this principle are Home Interiors & Gifts v. Commissioner, 73 T.C. 1142 (1980); Standard Asbestos Manufacturing & Insulating Company v. Commissioner, 276 F.2d 289, 293 (8th Cir. 1960), and Ken Miller Supply, Inc. v. Commissioner, 37 T.C.M. 974, 980 (1978).

4. Amount of the Organization's Income Devoted to Compensation

Where virtually all of an organization's income goes to its employees, a court may question the salaries. In Church of the Transfiguring Spirit v. Commissioner, supra, the Tax Court denied exemption to a church paying its ministers a housing allowance equal to almost its entire income. Similar cases involving churches are Southern Church of Universal Brotherhood Assembled, Inc. v. Commissioner, 74 T.C. 1223 (1980); Basic Bible Church v. Commissioner, 74 T.C. 846 (1980); Unitary Mission Church v. Commissioner, 74 T.C. 507 (1980); Bubbling Well Church of Universal Love, Inc. v. Commissioner, supra.

C. Factors Relating to the Compensation Itself

1. Criteria for Compensation.

An organization's board should establish clear criteria for an employee's compensation, spelling out the person's duties, responsibilities and measures of success in the position. However, if an organization prohibits inurement in its bylaws and does not actually pay an unreasonable amount, the fact that the organization does not set out criteria for or upper limits on compensation will not be fatal. The Church of the Visible Intelligence that Governs the Universe v. U.S., supra at 63.

2. Abrupt Increases in Compensation

Courts will be suspicious of large increases in salaries paid by an organization over a short period of time. Often, these increases reflect the employee's influence in the organization rather than any increase in the employee's duties or hours worked. An important factor in Founding Church of Scientology v. U.S., supra, was the steady increase in the compensation the organization paid to its founder over a short period of time. In the first year, the founder received $125 a week. His salary increased to

$250 the following year, and the next year he began receiving 10% of the organization's gross receipts, approximately $17,500. Thus, his salary increased almost three-fold in two years time.

Another case involving large salary increases is Incorporated Trustees of the Gospel Worker Society v. U.S., 510 F. Supp. 374, 379 (D.D.C. 1981), aff'd, 672 F.2d 894 (D.C. Cir. 1981), cert. den., 456 U.S. 944 (1982). There, three executives of an organization had salaries in 1970 of $25,000, $16,153, and $5,790. The salaries increased by 1978 to $100,000, $72,377, and $42,896. The court held that the sharp increases and the large amounts were "...at least suggestive of a commercial rather than nonprofit operation." The salary reflected the organization's improving fundraising capabilities rather than increased responsibilities for the employees.

Kermit Fischer Foundation, supra at 901, also illustrates this point. In that case, the trustee received no salary from the foundation for seven years. Then he retired, and began receiving salary at irregular intervals, which seemed to be tied to his need for income rather than to any performance of services.

3. Salary Fixed Many Years in Advance

One indication that a salary reflects an employee's control over an organization rather than his or her work is that it was established far in advance of the actual performance of services. For example, a salary for an organization's president established fifteen years in advance does not allow the foundation to adjust to changing conditions in the future. Mabee, supra at 616.

4. Substantiation of Duties Performed and Salary Paid

An organization should keep records indicating the duties performed by its employees and the hours those employees worked. The records will be particularly important if the organization seeks to justify compensation that appears unreasonable based solely on the amount involved. Kermit Fischer Foundation, supra, provides an example of the importance of this documentation. There, the foundation's sole trustee received approximately $40,000 a year in compensation for managing a small trust. The Service's expert testified that a reasonable salary for a trust of comparable size would be approximately $2,000 a year. The trustee attempted to justify his salary by arguing that he managed some real estate for the foundation, overseeing extensive construction and remodelling. However, he did not document the time he spent, the value of his services, or the amount of his compensation attributable to that work.

5. Contingent Compensation

A. IRC 162 Analysis

Reg. 1.162-7(b)(2) states that the form of compensation does not determine its appropriateness.

> Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

In IRC 162 cases, the courts have focused heavily on the concept of the employee's value to the organization in evaluating reasonableness of contingent compensation. If a large contingent payment results from inflation, wartime profits, or other reasons unrelated to increased productivity, the courts will scrutinize the payment very closely to see if it is justified on the basis of increased work and responsibility for the employees. Kafka, supra at A-7 (citing numerous cases). Courts in IRC 162 cases have approved of contingent payments as high as 60% of net profits, and have rejected payments as low as 20%. Id.

B. Application to Exempt Organizations

Although the cases involving exempt organizations do not expressly embrace the IRC 162 analysis of contingent compensation, the reasoning of the cases is quite similar. The focus is on whether the form of compensation serves a real and discernable business purpose for the exempt organization. One purpose contingent payments might serve is to relieve an organization of the need to maintain a large reserve to cover its risk of loss if a venture failed. In World Family Corporation v. Commissioner, supra, the Tax Court found that fund-raising commissions contingent on actually raising money were an "...incentive well-suited to the budget of a fledgling organization." The court approved of up to a 20% commission on funds raised, even though, under that system, the organization's founder and president was entitled to a 10% commission, or $20,000, for procuring a large stock donation in the late 1970's. A significant factor in the court's decision was that various state statutes approve commissions to fundraisers of up to 30%.

Another case held that a medical school's contingent compensation arrangement for its faculty promoted its exempt purposes by organizing the faculty

into a cohesive group and creating an efficient mechanism for fee collection. The school collected fees for its members' services and paid the members a salary from the funds. University of Massachusetts Medical School Group Practice v. Commissioner, 74 T.C. 1299 (1980).

Other cases approving of contingent compensation are Rev. Rul. 69-383, supra, ruling favorably on a hospital's percentage-of-income arrangement for doctors and G.C.M. 39674, supra, approving of a percentage-of-savings incentive compensation plan for a broad class of non-management hospital employees. Similarly, G.C.M. 39670, supra, ruled that payment of compensation from a separate tax-exempt fund established by a college to provide deferred compensation plus interest earned and bonuses for post-season games to athletic coaches did not create inurement. In all these cases, the compensation was negotiated at arm's length and was reasonable.

Courts appear most likely to disapprove of incentive compensation where there is no ceiling on the total compensation possible. The Tax Court emphasized this factor in finding inurement to the minister receiving a portion of congregants' tithes in People of God, supra at 132.

Also, where an arrangement creates a joint venture between the organization and the compensated party, or is a device to distribute the organization's profits, inurement exists. Lorain Avenue Clinic v. Comm., 31 T.C. 141 (1958).

C. Physician Recruitment

Recently, physician recruitment incentives have been the focus of much discussion. G.C.M. 39498, supra, considered incentives such as two year minimum income guarantees with no repayment obligation, low interest home and office mortgage loans, and a variety of other benefits. The Office of the Chief Counsel concluded that the package of incentives could not be determined in advance to be reasonable compensation. The G.C.M. reasons that the actual value of the incentives can vary from physician to physician. In some cases, the total value of the incentives could exceed the particular physician's value to the hospital. In that case, the total amount of the compensation to that physician would be unreasonable.

The Office of Chief Counsel is currently reconsidering G.C.M. 39498 and will likely change the focus in hospital incentive compensation cases to whether the value of the incentives exceeds the benefit to the community from that particular physician moving to the are rather than the business value to the employing hospital.

6. Evidentiary Issues

A. Required Evidence

The organization has the burden to prove its compensation is reasonable. Bubbling Well Church of Universal Love, Inc. v. Commissioner, supra; People of God Community v. Commissioner, supra. Generally, an organization will attempt to do so by offering evidence of comparable salaries in comparable industries. In the IRC 162 context, the Tax Court has held that a taxpayer's failure to offer evidence of comparable salaries is damaging but not fatal. Townsend v. Commissioner, 40 T.C.M. (CCH) 706, 716-17 (1980).

Because the burden of proof lies with the taxpayer, the courts do not draw an adverse inference from the Service's failure to offer evidence of comparables. E.g., Ken Miller Supply, Inc. v. Commissioner, 37 T.C.M. (CCH) 974, 980. However, a lack of evidence from the Service will make a court more likely to accept the taxpayer's evidence. Bullock's Department Store, Inc. v. Commissioner, 32 T.C.M. (CCH) 1168, 1181 (1973).

Raw data on comparability such as the Statistics of Income data (discussed below) generally requires expert testimony explaining its relevance before it will be given weight by a court. Kafka, supra at A-10.

B. Sources on Exempt Organization Compensation

The sources listed below are offered as examples of the type of information useful to establish comparable salaries. Citation here does not imply endorsement of any particular source, and omission from this list has no particular significance.

Many of the sources described below are available in public libraries. Information on publisher's addresses and prices for material is given where it was available at publication time to assist in obtaining difficult-to-locate material.

1. Council on Foundations, Foundation Management Report.

Published in even years by the Council on Foundations, 1828 L Street, N.W., Suite 300, Washington, D.C. 20036-5168, (202) 466-6512, $50. Reports salaries and benefits for staff in all types of grant-making foundations. Tables show salary data by foundation type, position and asset or grant level. Includes information on bonuses. In odd years, a report updating salary only is published.

2. "Compensation for Top Executives at Selected Non-Profits," Chronicle of Philanthropy, March 24, 1992.

Article lists salaries of 100 executives in various non-profits organized by type of organization.

3. National Charities Information Bureau, New York, New York, (212) 929-6300.

Publishes model board governance policies regarding compensation and other issues.

4. Abbott, Langer and Associates, Compensation and Non-Profit Organizations.

Based on information from 1,600 organizations, this 2 volume salary report analyzes salaries by type of organization, number of employees, total annual budget, geographic scope, region, state and metropolitan area and type of organization.

Non-Profit World, May-June, 1989 at 25, summarizes the Abbott, Langer data for 1989. Full reports for 1989 and other years are available from 548 First Street, Crete, Illinois, 60417, (708) 672-4200, $225.

5. American Society of Association Executives, Annual Survey of Association Executives' Compensation.

Call (202) 626-2723 for publication information.

6. Technical Assistance Center, 1991 National Non-Profit Wage and Benefit Survey.

Annual surveys no longer being published, but helpful for previous years. Call (303) 894-0103 in Denver, Colorado for publication information.

7. American Hospital Association, Hospital Management/Professional Compensation Survey, 1991.

Annual survey lists salary by position and number of beds in the hospital. Call (312) 280-6000 for more information.

8. John Zabka and Associates, Hospital Salary Survey Report, 1991-2.

Published annually in Oakland, New Jersey.

9. Wyatt Data Services, Hospital and Healthcare Report.

Published annually in Fort Lee, N.J.

10. Towers, Perrin, Foster & Crosby, Inc., Management Compensation Report for Not-for-Profit Organizations.

Annual study based on questionnaires completed by trade and professional associations, health and welfare organizations and "others". Available from Towers, Perrin at 600 Third Ave., New York, New York, 10016, (212) 661-5080.

B. General Sources On For-Profit Business Salaries

1. IRS' Corporation Source Book of Statistics of Income, Publication 1053.

Lists income statements and balance sheets by a two-digit classification referred to in the Enterprise Standard Industrial Classification ("ESIC") Manual prepared by the Statistical Policy Division of the U.S. Office of Management and Budget.

2. Research Institute of America, "Executive Compensation Reports".

Published annually. Contains information on 63 detailed subgroups within seven broad industry groups: manufacturing; wholesale distribution; retail distribution; financial services; nonfinancial services; construction, contracting & extraction; and transportation, communications and utilities. The broad industry groups are also broken down by sales volume. Industry subgroups follow the ESIC categories.

3. Top Management Report.

Arranged by sales/revenue volume of the companies.

4. Business Week.

Annual survey of executive compensation, published around the first week of May.

5. Forbes.

Annual survey of executive compensation published around the first of June.