

# IRS Takes Dim View of Supporting Organizations

*By Bruce R. Hopkins*

One of the principal contemporary concerns of tax-exempt organizations is the reasonableness of compensation they pay to employees and consultants. The reason is that the payment of excessive compensation can, because of the doctrine of private inurement, cost the organization its exempt status. In some instances, in addition, the intermediate sanctions rules can apply.

The reasonableness of an element of compensation is a question of fact — not law. This is the case whether the payment involved is a salary, fee, bonus, commission, retirement benefit, or other form of executive and like compensation.

## **Criteria Developed**

The courts over the years have developed criteria for ascertaining the reasonableness of compensation. Traditionally, use has been made of a multi-factor test — with the number of factors (five to more than 20) dependent on the court.

Many of these court opinions concern compensation paid by for-profit companies; nonetheless, the rules that have been developed apply equally in the not-for-profit context.

Essential factors include the amount and type of compensation paid by comparable employers, consistency of compensation within the entity, the amount of time devoted to the position, and the employee's role, experience, training, and education.

In recent years, however, the multi-factor test has been severely criticized. Its most vociferous critic is the U.S. Court of Appeals for the Seventh Circuit.

In 1999, that appellate court (in a case involving the Exacto Spring Co.) portrayed the multi-factor test as unreliable and unpredictable. In its stead came the independent investor test. Some other federal courts of appeal followed the Seventh Circuit's lead. This gave rise to the prospect of divergent tests: one for not-for-profits and one for for-profits.

Recently, however, the First Circuit looked at this aspect of the law for the first time. The case concerned bonuses paid to two employees, who are not principal executives of the company, by an oil and gas sales corporation (Haffner's Service Stations, Inc.). This court concluded that the independent investor test "was not the exclusive answer to the problem."

In a striking observation, the court said that there is "always a balance to be struck between simplifying doctrine and accuracy of result, and for the present we think that multiple factors often may be relevant."

The court concluded that the bonuses were unreasonable compensation. The factors reviewed were the company's performance, comparability of compensation, and the nature of the services provided by the recipients of the bonuses. It found that these individuals were not the "strategic brains" of the company and that "many of their functions were mundane."

The court concluded that a "neutral" employer would not have paid them "handsomely for producing results for which others, or merely good economic times, were responsible."

### **Test Lives On**

Consequently, the multi-factor test lives on. It continues to be the standard by which the compensation paid by tax-exempt organizations is scrutinized. While it is true that judges are not trained to pass on these factual matters, there is no preferable approach.

Nonprofit organizations do not, in any event, have "investors." The First Circuit has summarily postponed, if not eliminated, any imminent demise of the multi-factor test, even in the for-profit setting.

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