

EXECUTIVE COMPENSATION IN CATHOLIC SOCIAL SERVICE AGENCIES

By

Sister Melanie DiPietro, S.C.
Professor Alison Sulentic
Sister Linda Yankoski, C.S.F.N.

I. Introduction

This paper presents the tools for a detailed case study of the legal, financial and ethical considerations involved in executive compensation planning for non-profit corporations. In particular, we present a case study of the relationship between the board of directors of a hypothetical non-profit Catholic social services organization and its executives. The case study asks the student to examine the legal and managerial aspects of the proposed compensation arrangements and evaluate them in light of Catholic social teachings.¹

This case study is suitable for use in undergraduate and professional classes that cover issues such as executive management, tax-exempt organizations, compensation planning, employee benefits or worker's rights.

II. Background

In the United States, the non-profit sector has served as the buffer between the individual and the state, as well as the source and proving ground for innovations in public policy.² Indeed, volunteerism in the non-profit sector is a hallmark of American democracy.³ The historical role of the executive leadership and staffing of non-profit corporations, however, has yielded to the inescapable need for professionalism in the delivery of health care, education and other social service agencies. In theory, a high degree of professionalism enhances the quality of the services received by the beneficiaries of the nonprofit sector.

“Capacity building” and “social entrepreneurship” are popular strategies in management literature in the non-profit sector. Both principles are often deemed to be of benefit to a non-

¹ For further discussion of Sister DiPietro's and Professor Sulentic's work on the pedagogy of Catholic social thought, see Melanie DiPietro, S.C., and Alison M. Sulentic, *The Integration of Catholic Social Thought Into Workplace Law Courses*, paper presented at Vth International Symposium on Catholic Social Thought and Management Education (Universidad de Deusto, Bilbao, Spain July 2003). This paper explains that although we (Sister DiPietro and Professor Sulentic) recognize that the introduction of Catholic social thought in a law school curriculum might have a formative effect on a Catholic law student, we believe that Catholic social thought may also be studied as a body of thought regardless of catechetical interest or intent on the part of the student and instructor.

² Michael O'Neill, *THE THIRD AMERICA: THE EMERGENCE OF THE NONPROFIT SECTOR IN THE UNITED STATES* 1-2, 67-122; 174 (Jossey Bass Publishers 1989).

³ Alexis de Tocqueville, *DEMOCRACY IN AMERICA* (Doubleday Anchor 1969)(1835); Peter L. Berger and Richard John Neuhaus, *TO EMPOWER PEOPLE: THE ROLE OF MEDIATING STRUCTURES IN PUBLIC POLICY* (American Enterprise Institute 1977).

profit organization because proper application of the principles should theoretically increase the organization's efficiency in rendering services and result in a better use of charitable resources. The practical application of these concepts is evident in two business strategies that have gained increasing popularity in the non-profit sector: (1) the development of revenue streams outside the exempt purpose of the corporation⁴ and (2) compensation incentives for professional executives.

The case study set forth below offers the student the opportunity to examine the legal and managerial problems which may arise from an inappropriate application of "capacity building" and "social entrepreneurship" to the activities of an exempt charitable corporation. The student may explore whether such strategies might call into question both the tax-exempt status of the non-profit corporation and the public policy support of the tax-exempt goal. In particular, we examine compensation strategies borrowed from the for-profit sector, including revenue-sharing, with regard to

- the imposition of significant sanctions on both the employee and the employer pursuant to Section 4958 of the Internal Revenue Code;
- the loss of tax-exempt status under Section 501(c)(3);
- the implications of the fiduciary obligations of the board of governors to the organization and its beneficiaries; and
- the extent to which Catholic social teachings concerning just wages and meaningful work may impact such compensation arrangements.

In examining the facts of this case study, the student is invited to consider the impact of Catholic social teachings on an organization that is publicly affiliated with the Roman Catholic Church. The student is asked to consider whether principles contained in Catholic social teaching have any relevance to organizations with no public affiliation to the Roman Catholic Church.

II. Guide to Materials

The basic working premises of Catholic social thought may be introduced to a student through a variety of pedagogical techniques including, for example, lecturing, Socratic dialogue, close reading of texts and active problem solving. The choice of method and the effectiveness of its presentation is largely dependent upon the preferences of the instructor and the goals of the course. We believe that an instructor may inspire reflection on the issues raised by Catholic social thought through any of these methods.

In this paper, however, we present a set of materials that invites students to explore the themes of Catholic social thought through a case study rather than through lecture materials. Our

⁴ Jody Blazek, TAX PLANNING AND COMPLIANCE FOR TAX-EXEMPT ORGANIZATIONS 504 (John Wiley & Sons, Inc. 1999; Supp. 2003).

goal is to provide a student with a realistic example of a business problem which he or she might expect to encounter in the management of a non-profit social services corporation.

To this end, we have developed a packet of student materials that includes not only a narrative of the facts of the hypothetical, but also supplementary materials that are representative of the resources that a non-profit decision-maker might have at his or her disposal. The extent to which a teacher chooses to rely on any particular document will largely depend upon the objectives of the course in which this unit is used. For example, a law student might be expected to analyze the excerpts from the statute and regulations in close detail, while a management student may find it more useful to examine the documents on institutional theory. In either case, our goal is to create an open-ended vehicle for a realistic examination of these principles.

In particular, we offer the following materials:

- A problem set (intended for student use), composed of
 - a narrative description of the relationship between the executive and the Board of Directors of the corporation;
 - excerpts from the materials that the executive studied as she prepared the proposal;
 - excerpts from the articles of incorporation of the corporation;
 - a memorandum from the organization's lawyer to a subcommittee of the Board;
 - a set of relevant provisions from the Internal Revenue Code and the related Treasury Regulations;
 - excerpts from Catholic social teaching.
- Teacher's materials, including
 - a set of suggested discussion questions to guide the students' review of the materials;
 - a memorandum on the historical development of government regulation of incentive compensation. This memorandum provides detail concerning the history of regulation which may be useful to the instructor.⁵

⁵ This memorandum is based on background materials prepared by law firm of Buchanan Ingersoll PC, and available on the firm's website at www.bipc.com.

The factual narrative explains the development of Saint Hedwig's Center,⁶ a nonprofit social services corporation founded by the Sisters of Prudence (a hypothetical religious institute), managed by a lay board and a lay executive director, Judy Kay. The central question that the narrative raises is the proper means of compensating executives who are employed by an exempt public charitable corporation. This question is posed directly by Judy Kay, as she struggles to make sense of seminar materials that she has gathered and the reality of the competitive job market in which she participates and from which she is expected to recruit new employees for the corporation.

This question could, in theory, be answered by examining the Articles of Incorporation, the Internal Revenue Code and the related treasury regulations, as well as by studying management theory on social entrepreneurship. Our desire, however, is that the narrative inspire students to probe the value choices which undergird these professional materials. By juxtaposing the excerpts from Catholic social thought against the values represented by these materials, we hope to expose not only the core elements of Catholic social thinking but also the core assumptions at the base of the legal and managerial materials. We have deliberately given Saint Hedwig's Center a "Catholic identity" in order to encourage the students to consider whether formal affiliation with the Roman Catholic Church would affect the manner in which organization confronts this challenge.

We intend these materials to lead to an open-ended discussion of the relationship between the external influences on a tax-exempt charitable organization and the values that are integral to the organization's mission.

⁶ For more information about Saint Hedwig, see Donald Attwater & Catherine Rachel John, *THE PENGUIN DICTIONARY OF SAINTS* 170 (3d. ed. 1995); Anne E. Neuberger, *STORIES OF SAINTS THROUGH THE CENTURIES* 74-79 (Twenty-Third Publications 1999).

EXHIBIT 1

Saint Hedwig's Center
Student Problem Set

1. Facts
2. Excerpts from Materials that Judy Collected at the Seminars She Attended
3. Excerpts from Articles of Incorporation of Saint Hedwig's Center
4. Memorandum from Dorcas Shelby, J.D.
5. Excerpts from Statutory and Regulatory Provisions
6. Excerpts from Catholic Social Thought

FACTS

The Sisters of Prudence founded Saint Hedwig's Center for Social Services in 1978. The Sisters intended the Center to be a nonprofit city-based organization that would offer social services to all needy children in the city. The city in which Saint Hedwig's is located has been designated by the federal government as a "deteriorating community." Recognizing that the declining number of vocations made the day-to-day management of the Center an unwieldy task for their already over-burdened order, they placed control of the business affairs of the corporation in a lay board.

The Sisters' commitment to the Catholic social tradition provided the core vision of the Center's management criteria. In fact, the Center's name was deliberately chosen to reflect the social ministry of Saint Hedwig, Duchess of Poland, who used her personal fortune to alleviate the burdens of the poor and sick in thirteenth-century Poland. The Center always celebrated Saint Hedwig's feast day on October 16 by throwing a block party at the Center, during which clients and visitors received free loaves of bread baked in the shape of a shoe. This tradition honored Saint Hedwig's custom of delivering bread to homes and the legend that she gave her own shoes to a poor woman who needed them.

The first employee of the Center was Judy Kay, who continues to hold the position of Executive Director. Judy, an idealist at heart, was committed to living in the city that the Center was dedicated to serving. She and her family moved into the community shortly after she was hired, and have lived in the same house ever since. Judy attended Mass regularly at Saint Elizabeth of Hungary Parish, enrolled her children in Saint Elizabeth School, and participated actively in civic life of the city. She became well-known as a leader and as a reliable volunteer in the Catholic community.

For twenty-five years, Judy devoted her professional life to building the Center and serving the city. For most of those years, the Center was a one-woman operation. Judy discerned the community's needs, designed the programs that the Center offered and sought the funding it required. Drawing on her prior experience as a counselor for a drug-and-alcohol rehabilitation center in the 1970s, Judy developed the Center as a model of integrated services. The Center's program combined social services, counseling, residential care, and independent apartment living for its clients who were finishing school and rehabilitation. The Center is beginning to promote home ownership and small business development activities for its "graduates."

In many ways, Judy's efforts have now paid off, as the Center has emerged as a flagship organization and the staff of the Center is now composed of 25 full-time and 15 part-time employees. Judy herself is recognized by federal and state funding agencies, the private philanthropy community and her peer group as a leader in her field. In fact, several non-profit and business organizations have tried to recruit her away from the Center, but Judy remains committed to the organization and the needs of her service population.

For many years, Judy has received significantly less compensation than her peers in similar organizations. Although she always suspected that she was underpaid, she was so committed

to the growth and mission of the organization in its formative years that she placed her personal financial objectives below her goals for the Center. She reasoned that if Saint Hedwig could give a poor woman the shoes from her own feet, she, Judy, could make due without asking for a raise.

As the Center became financially stable and increasingly well-known, however, Judy began to reconsider whether it was still appropriate to accept a salary that she knew to be undervalued. As she looked into the future, she knew that the work at the Center would far outlive her own career. Could the Center possibly recruit someone to do what she did for the salary she received?

As Judy pondered this question, she began to research the market salary for positions like her own. She learned that the compensation of executives in hospitals and universities in her city exceeds her own. She did not think that the work of these executives was more complicated than her own. She examined copies of the Form 990 filed by organizations that she thought were similar to her own. She asked many business colleagues who work in private industry about the salary ranges of persons holding management and executive jobs similar to hers. The conclusion that she was—and had been, for many years—underpaid seemed irrefutable.

Recently, Judy attended several seminars on capacity building and social entrepreneurship in the nonprofit sector. One of the seminars that Judy attended featured a presentation by a lawyer who argued strongly in favor of diversifying the revenue base of a nonprofit corporation. Other speakers emphasized the difference between the development of entrepreneurial non-profit organizations and those that merely replicated traditional services. Nearly all of them emphasized the importance of recruiting and keeping “good people” in key positions.

As Judy listened to the speakers define “social entrepreneurs,” she recognized herself. She had designed programs that were unique. She helped organizations all over the United States to replicate her model of service. She was a leader and her employees were very good at their jobs as well. Judy took to heart a clear message: if the Center was to continue to operate as a leader in the field and to attract dynamic personnel, she would have to address the compensation arrangements. If the seminar speakers were right, she would lose good talent to more entrepreneurial nonprofit organizations and perhaps even to the private sector.

Over the next few weeks, she began to study all the literature on social entrepreneurship and capacity building that she could find. She scoured the Wall Street Journal and the business section of the local newspaper for examples of social entrepreneurship in her own city. She read about mergers and joint ventures among non-profits and between non-profits and for-profit organizations. She began to realize that the language of the non-profit world had changed. She noticed that hospitals now referred to “product lines” rather than “services.” Once, she called a nursing home for her aunt. When she said she wanted to ask about admission, the receptionist transferred her to the “marketing department.” The more Judy read, the more she recognized that her career in non-profit administration was transforming into a career in business administration.

Judy set about designing a business plan to increase the capacity of her organization. Recalling the lawyer's comments at the seminar, she planned methods of diversifying revenue streams and designed compensation packages that would help her retain her talented employees and attract new and promising executives.

Judy presented her plan to the Board at its semi-annual meeting. Judy explained that in order to serve the city to the greatest extent possible, the Center needed a secure financial base. She explained in detail the activities that brought revenue into the Center, including her own personal efforts to raise funds from the private community and to get increased grants. She also suggested that there many possibilities for developing joint ventures with other non-profits and for-profit organizations and perhaps with staff members, Board members and other people of good will in the city. In order to implement this strategy, Judy asked the Board to approve a compensation scheme that would guarantee that she and several key staff members receive a prorated percentage of the revenue stream from each product line, up to a specific fixed cap.

The Board was used to Judy's creative inspiration, but this time her creativity seemed to have run ahead of them.

Bob Smith, an accountant whose private clients were primarily small for-profit corporations, nodded as she described her plans. At last she was speaking the language he understood. No more happy clappy talk; now she was using facts and figures—something a man could get his mind around.

Charlie Rivera gazed at Judy impassively. He pondered the fact that the woman who spoke so succinctly about revenue streams and joint ventures was the same person who had held his wife's hand while she sobbed over her disappointment that the INS had delayed their adoption of a Cambodian baby for the third time in six months. The same person who had called INS officials and persuaded them to expedite the paperwork that had seemed so insurmountable just days before. The same person who was the godmother of his two-year-old daughter, now safe and sound, Cambodia and poverty far behind her.

Gina Aiello's mind raced through question after question as Judy spoke. Gina was doing her duty as a Board member for free. She understood the need to use precious resources to keep the Center afloat. She could hardly believe that Judy of all people was telling her that the resources should go to something else—to someone else. What was Judy suggesting? Could she really be suggesting that she get a commission? What happened to her "Catholic values"? Gina sniffed. Now it shows, she thought. Judy's no Mother Teresa. She's no Hedwig. She's just an old fraud out to make a dime like the rest of us.

Suddenly Gina could contain herself no longer. The frustration within her burst forth in a torrent of words. "How can you suggest these things and look at yourself in the mirror in the morning? We are a charitable organization. You are the leader of a non-profit corporation. We are about mission, not money. And you should know this better than anyone. You have talked for years about your "call" to community service and now you're telling me that you

want a percentage of the money that trickles into this place? I cannot condone spending the Center's money on executive salaries. What do you think the Center stands for?"

Charlie, pulled out of his reverie by this speech, glanced at Judy. She was white-faced, but her features betrayed no emotion.

"I'm still committed to the mission, Gina," she said. "I'm just telling you something that I guess you don't want to hear. Even the charitable exempt organization world has changed. If the Center is to survive, we've got to treat it like the business it is. Give the staff the respect they deserve. Recruit the best we can get. That takes a modern business plan and a compensation plan that people whom we might want to hire away from the for-profit sector can recognize. That's all I'm talking about. And that is absolutely vital to the Center and to its mission."

Bob intervened. "You know, Gina, what Judy says makes a lot of sense to me. You read about this type of thing every day in the Wall Street Journal, in Business Week, even in our newspapers. It's the way of the future."

Charlie saw Gina clench her jaw. He raised his hand, "Now, folks, let's not take up sides too quickly. I think we should do this the old-fashioned way. Let's get as much information as we can. Judy, you give me your files, I'll appoint a subcommittee to look at them and to find out any other points of view, and we can take this up at a special meeting of the Board in a month or two."

Gina looked at Judy and then back to Charlie. It was true that she respected Judy—always had and always thought she would. There must be something more than greed to this. It just seemed so wrong. Finally, she spoke. "I can agree to that, with one condition. You've got to talk to a lawyer. It just doesn't seem right that an organization like ours could take charitable dollars and turn them over in inflated executive salaries. If your committee agrees to meet with a lawyer, I can wait for more information before I decide how to vote."

"It's not 'my' committee, it's a board committee," Charlie pointed out. "I move that a subcommittee composed of Gina, Bob Smith here, and two other committee members---oh, and, of course, Judy—look over this information and report back in two months. All in favor, say 'Aye.'"

The Board cast a unanimous vote in favor of the subcommittee.

EXCERPTS FROM MATERIALS THAT JUDY COLLECTED AT THE SEMINARS SHE
ATTENDED

Increasing Your Revenues and Motivating Your Executives – Points to Ponder

By

Marvin Motivator⁷

Founder and CEO of Marvin's Magnificent Money Management Consultants, Inc.
(*"When Marvin Motivates, Money Moves!"*)

- A nonprofit organization cannot accomplish its objectives without sufficient revenues. Remember, Marvin says

No Margin, No Mission!

- Provided that appropriate limits are observed, the Internal Revenue Code permits nonprofit organizations to retain tax-exempt status even if the organization engages in activities that generate a certain amount of business income from activities not related to their exempt purpose, as long as the organization complies with rules concerning the payment of taxes (known as UBIT) on such income.
- Tax-exempt nonprofit entities such as integrated delivery systems often engage in joint ventures with for-profit organizations or create for-profit subsidiaries without jeopardizing their tax-exempt status.
- To compete effectively in the marketplace, nonprofit organizations need to recruit executives who understand the professional and economic demands of the business world and who compete effectively with for-profit organizations. To do this, a nonprofit organization must offer compensation packages that bear a reasonable relationship to the compensation package which such an executive would be offered by a for-profit corporation.

Incentivize = Maximize!

When you incentivize your employees, you maximize your mission!

⁷ Marvin Motivator is an entirely fictitious product of Professor Sulentic's imagination. The views set forth in this material are for the purposes of educational discussion and do not necessarily represent an accurate view of the non-profit world or the views of any of the authors of this paper.

*Are You a Social Entrepreneur?
Answer These Five Easy Questions and You'll Find Out!*

Isabelle Intellectelle⁸
Staff Writer, *Doing Good Magazine*

You've read about social entrepreneurship. You know it when you see it. It's that certain *je-ne-sais-quoi* that radiates from someone who does it all—growing a business and changing the world. It's that smile that says, "I'm doing good and I'm having fun doing it."

Do you have what it takes to call yourself a social entrepreneur? To find out, take a minute to answer these five simple questions. Perhaps the glow that surrounds your nonprofit organization really starts with you!

1. *Do you have a heart for social good and a head for business?* Too often, we see the world as divided between do-gooders and hard-headed business executives. If you bring a savvy sense of business dynamics to your non-profit work, you're acting like a social entrepreneur!
2. *Are you an innovator?* Do you see real social needs that other organizations are ignoring? Many non-profit organizations have thrived for years on the old adage—"If it ain't broke, don't fix it." Good advice for the organization that is comfortable addressing social problems through tried-and-true strategies. But if you're the kind of manager who brings creative new ideas to the forefront of your nonprofit community, you're a social entrepreneur!
3. *Are you a problem-solver?* If you don't let a small budget stand in the way of a great idea, you've got the markings of a social entrepreneur. As Admiral Perry said on his way to the North Pole, "Find a way or make one!"
4. *Are you a networker?* A social entrepreneur can often see connections between nonprofit objectives and the strategies that for-profit corporations have adopted with great effectiveness. It's not called "building capacity" for nothing—these social entrepreneurs have learned that some of the tricks of the for-profit trade have helped them establish a revenue base and a workplace ethic that revitalizes the momentum and resources of their non-profit organization.
5. *Are you a motivator?* Let's face it—chances are that you've got to work with other people to make your dream come true. Even if you could build a dynamic nonprofit organization on your own, clients, suppliers, advisors and regulators all require your attention. If you have the personality and skills to keep them on track, you're showing the signs of a successful social entrepreneur!

⁸ Likewise, Isabelle Intellectuelle is a product of Professor Sulentic's over-active imagination. Isabelle has obviously consulted some of the more reputable literature in this area, including Sherrill Johnson's capable literature review. See generally, Sherrill Johnson, Canadian Centre for Social Entrepreneurship, *Literature Review on Social Entrepreneurship* (November 2000), available at (reviewing United States and Canadian sociological literature).

*Preserving Your Catholic Identity From the Pressure of Outside Influences*⁹

Institutional theory of organizational behavior suggests that organizations interacting in the same field¹⁰ tend to become homogeneous.¹¹ The process by which this homogenization occurs is known as *isomorphism*. For example, the process of *coercive isomorphism* occurs when organizations seeking government aid necessarily adapt to government-established rules, guidelines, and procedures for the receipt of funds and, in this process, become increasingly similar.¹² *Mimesis isomorphism* refers to "the tendency of organizations to mimic strategies in other organizations."¹³ In other words, organizations will often imitate the processes and strategies of other successful organizations. *Normative isomorphism* occurs when members of an organizational field individually and collectively aim for similar external standards.¹⁴ The introduction of professional standards through educational or ethical norms may result in normative isomorphism.

These principles suggest that nonprofit organizations with "open boundaries" will become similar to the dominant secular organizations within their fields.¹⁵ The profound influence of environment on organizational development suggests that nonprofit organizations should observe closely "values, processes, and goals held by those most intimately involved in the organization's workings."¹⁶ A nonprofit organization that is founded with a distinct set of normative ideals may gradually find these ideals in conflict with or subsumed by the dominant

⁹ This material derives from Sister Linda Yankoski's Ed.D. dissertation, entitled *The Soul of the Matter: The Impact of Government Funding on the Catholic Identity and Mission of Holy Family Institute, 1900-2002* (Duquesne University 2003). In addition, a version of the material contained in this portion of the paper will also appear in a paper to be presented by the same authors at the ARNOVA conference to be held in Denver, Colorado in November 2003.

¹⁰ An organizational field encompasses "those organizations, that in the aggregate, constitute a recognized field of organizational life: key suppliers, resource and product consumers, regulatory agencies, and other organizations that produce similar services and products." See P.J. DiMaggio and W.W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, 48(2) AMERICAN SOCIOLOGICAL REVIEW 147-60 (1983).

¹¹ See P.J. DiMaggio, *The Relevance of Organization Theory to the Study of Religion*, in N.J. Demerath III, P.D. Hall, T. Schmitt & R.H. Williams, eds, SACRED COMPANIES: ORGANIZATIONAL ASPECTS OF RELIGION AND RELIGIOUS ASPECTS OF ORGANIZATIONS 7-23 (Oxford University Press 1998).

¹² H.S. Stout & D.S. Cormode, *Institutions and the Story of American Religion: A Sketch of a Synthesis* in SACRED COMPANIES, *supra* note 11 at 69.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.* at 67-69. Organizations are constantly evolving in response to their environments and open-systems theories maintain that organization boundaries are permeable. See W.R. Scott, ORGANIZATIONS: RATIONAL, NATURAL AND OPEN SYSTEMS (Prentice-Hall 1987).

¹⁶ See W.G. Tierney, *Organizational Culture in Higher Education: Defining the Essentials*, 59(1) J. HIGHER ED. 2, 3 (1988).

values of the environment in which it operates. In these cases, succumbing to isomorphic influences, whether coercive, mimesis or normative, may threaten the very ideals that originally defined the mission and identity of the nonprofit organization.

Consider, for example, a Catholic social services agency affiliated with a Catholic religious institute. Assume, moreover, that the agency is founded with a clear mandate to pursue the ethical directives and mandates of the religious institute. Can this mandate realistically remain central to the organization's decision-making process when the hospital begins to operate in an environment that also comprises the influence of government regulation and funding, professional organizations and associations and peer organizations? According to the theory of isomorphism, a Catholic social services agency characterized by open boundaries will be influenced by the other entities in its organizational field. Figure 1 depicts the principal isomorphic influences on a Catholic social services agency:

- the Catholic Church through the local bishop or the sponsoring religious institute
- government contracts for funding and professional organizations and associations, and
- peer organizations.

Unless the isomorphic tendencies are actively managed, the authority, resources, and culture of the Catholic social services agency may be impacted to a greater extent by the entities with which it interacts, such as peer organizations or government and professional organizations, than the values of the affiliated religious group.

The Catholic social services agency illustrated in Figure 1, for example, may experience the conflict between internal values and external culture in some areas that are obvious and others that are more difficult to detect. Well-known conflicts between Catholic norms and environmental influences emerge, for example, in the conflict between Catholic teaching on abortion and other reproductive services and the counseling of teenagers at risk. Less obvious, however, are conflicts between Catholic norms on workplace justice and wage equity and the trends in compensation planning emerging from the for-profit and, now, the non-profit sector. In these instances, it is possible that a gradual trend to homogenization could indeed occur, simply because the internal identity of the social services agency is not strong enough to withstand the isomorphic influences of external trends.

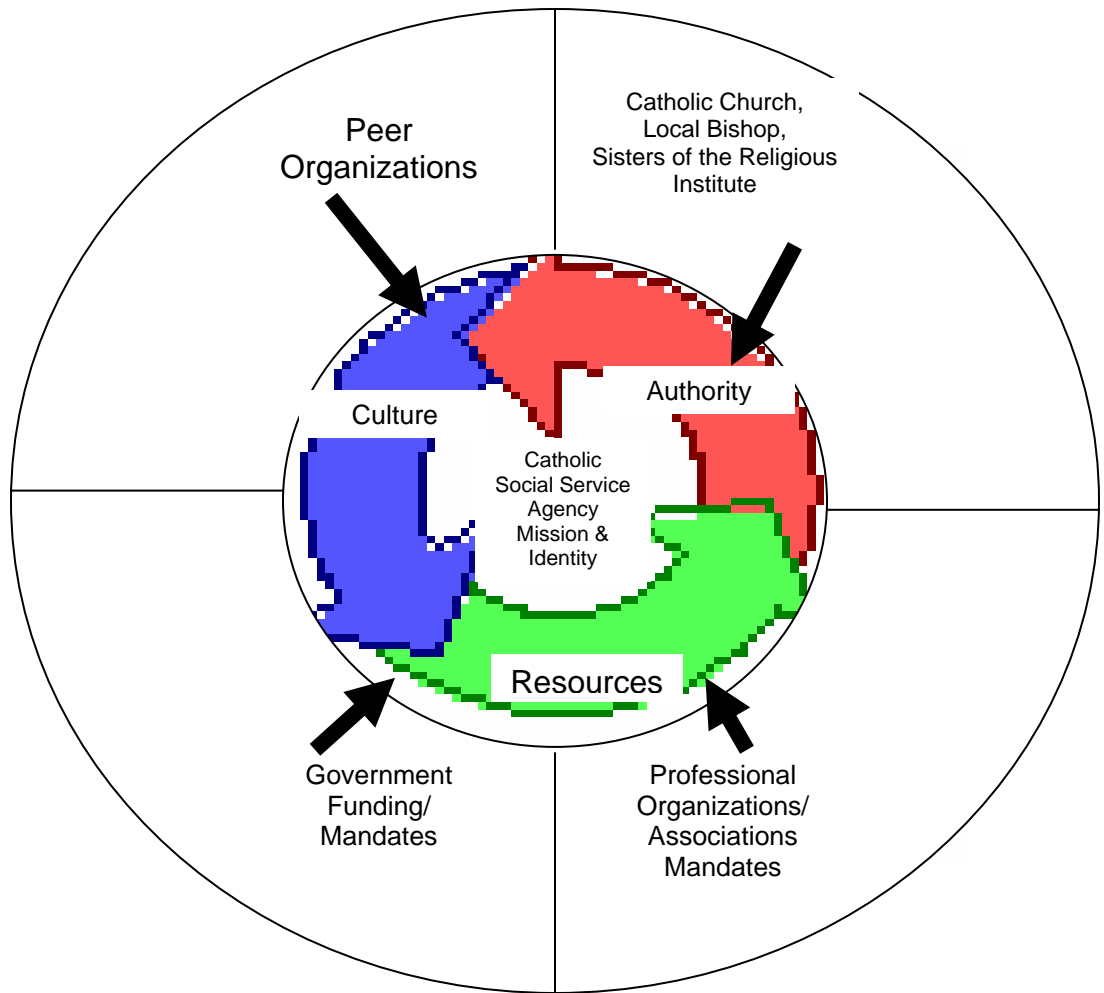


Figure 1

EXCERPTS FROM THE ARTICLES OF INCORPORATION OF
SAINT HEDWIG'S CENTER¹⁷

ARTICLE III.

The Center is organized exclusively for charitable and educational purposes, including the making of distributions to organizations that qualify as exempt organizations under Section 501(c)(3) of the Internal Revenue Code or the corresponding section of any future federal tax code. Specifically, the Center shall provide adoption, residential care and social services for children, educational programs including the maintenance of elementary and secondary programs, and shall carry on all other activities in furtherance of these purposes. All programs in furtherance of these purposes shall be provided in accord with the teachings of the Roman Catholic Church and the traditions of the Sisters of Prudence.

ARTICLE V.

No part of the net earnings of the Center shall inure to the benefit of, or be distributable to its members, trustees, officers or other private persons, except that the corporation shall be authorized and empowered to pay reasonable compensation for services rendered and to make payments and distributions in furtherance of the purposes set forth in Article III hereof. No substantial part of the activities of the Center shall be the carrying on of propaganda, or otherwise attempting to influence legislation, and the Center shall not participate in, or intervene in (including the publishing or distribution of statements) any political campaign on behalf of or in opposition to any candidate for public office. Notwithstanding any other provision of these articles, the Center shall not carry on any other activities not permitted to be carried on

- (a) by a corporation exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code or the corresponding section of any future federal tax code or
- (b) by a corporation, contributions to which are deductible under Section 17(c)(2) of the Internal Revenue Code or the corresponding section of any future federal tax code.

ARTICLE VI

Upon the dissolution of the corporation, assets shall be distributed for one or more exempt purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code or the corresponding section of any future federal tax code or shall be

¹⁷ These Articles are adapted from the sample language of incorporation set forth in I.R.S. Pub. 557, *Tax-Exempt Status for Your Organization* 19-21 (Rev. May 2003). These are not the Articles or paragraphs that the authors would recommend for church-related institutions without specific legal counsel review. These paragraphs are simply illustrative of paragraphs which might qualify the organization for exempt status.

distributed to the federal government or to a state or local government for a public purpose. Any such assets not so disposed of shall be disposed of by a Court of Competent Jurisdiction of the county in which the principal office of the corporation is then located, exclusively for such purposes or to such organization or organizations, as said Court shall determine, which are organized and operated exclusively for such purposes.

MEMORANDUM¹⁸

CONFIDENTIAL ATTORNEY-CLIENT WORK PRODUCT

TO: Charles Rivera
Chair, Special Subcommittee on Executive Compensation at Saint
Hedwig's Center
FROM: Dorcas Shelby, J.D.
RE: Executive Compensation Proposal
DATE: October 1, 2003

I. ISSUE

The purpose of this memorandum is to describe Section 4958 of the Internal Revenue Code (the "Code"), the related regulations and other concerns related to the proposal that Saint Hedwig's Center (the "Center") enter into a compensation arrangement with certain select executives ("Executives"). Pursuant to the proposed arrangement, the Executives would receive a percentage of any revenue streams generated by the product lines of the Center (defined to include gross revenues from exempt program activities, fundraising, government and private foundation grants, and revenues from joint ventures initiated between the Center and any other party, whether for-profit or not). You have indicated that the Board of the Center plans to evaluate whether the proposed arrangement would violate the private inurement and private benefit prohibitions applicable to organizations exempt from taxation under Section 501(c)(3) of the Code.

No opinion has been requested and none is offered with respect to whether the proposed arrangement would constitute an employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974, as amended, nor with respect to whether this proposed revenue stream would violate the Articles of Incorporation of the Center or any other applicable provision of state law.

III. SHORT ANSWER

[See Discussion Question _____. Students will provide this, based on their understanding of the legal background.]

IV. FACTS

Saint Hedwig's Center is a charitable corporation that is exempt from taxation under Section 501(c)(3) of the Internal Revenue Code. The Board is considering a

¹⁸ Dorcas Shelby, J.D., is a fictitious character. This memorandum is offered strictly as a fictional supplement to the teaching unit on the hypothetical non-profit corporation, Saint Hedwig's Center. It is not offered as legal advice and is not intended to substitute for the legal analysis of any problem which any reader might encounter in his or her personal or business affairs.

proposal to approve a compensation scheme that would guarantee that several key staff members receive a prorated percentage of the revenue stream from each product line, up to a specific fixed cap.

V. LEGAL BACKGROUND

Section 4958 of the Code imposes certain excise taxes related to excess benefit arrangements between tax-exempt organizations and disqualified persons.

The following is a summary of the principles used to evaluate the proposed compensation arrangement as found in selected court and IRS materials.

A. I.R.S. Provisions for Violations of General Prohibition Against Private Inurement and Private Benefit.

Section 501(c)(3) of the Internal Revenue Code forbids the inurement of earnings in whole or in part to the benefit of "private shareholders or individuals." Treas. Reg. § 1.501(c)(3)-1(c)(2). The purpose of this prohibition is to prevent the tax-exempt organization from operating for the benefit of "insiders" who, in theory or in practice, influence the direction of the organization. In simple terms, the prohibition against private inurement prevents the diversion of assets away from the exempt purpose of the organization and towards the private objectives or gain of insiders who are usually the management, directors or any person who effectively controls the organization. The prohibition against private inurement theoretically safeguards the organization's exempt purpose by insuring that no insider may receive value from that organization without conferring a positive benefit in return. Any value received by the insider for services rendered to the organization must be determined by an objective fair market value standard.

The prohibition against private inurement is so integral to the understanding of federal tax-exemption that even a minimal amount of private inurement may theoretically result in the loss of exempt status. Until the mid-1990s, in fact, disqualification for continued exempt status was the only sanction available to the IRS in response to a violation of the prohibition against private inurement. In 1996, however, Congress amended the Internal Revenue Code to provide for "intermediate sanctions" under Section 4958. The new statutory provision was first amplified by proposed regulations issued in 1998 and later by temporary regulations issued in 2001. The Treasury Department promulgated final regulations on January 23, 2002. See 67 Fed. Reg. 3076 (2002).

A private benefit is a benefit to a private person that is outside the organization (not a director or management) and is more than incidental. Unlike private inurement to disqualified individuals, which is absolutely prohibited, certain insubstantial private benefits are permissible, provided that the benefit is both qualitatively and quantitatively incidental. See Gen. Couns. Mem. 37789 (Dec. 18, 1978).

B. How Does the Law Concerning Private Inurement Work?

1. Key Definitions in Section 4958 and the Final Regulations

a. Disqualified Person

Under Section 4958(f)(1), there are three categories of "disqualified persons":

- any person who was "in a position to exercise substantial influence over the affairs" of the tax-exempt organization during the five-year period ending on the date of the transaction in question;
- any member of such a person's family;¹⁹ and
- a 35-percent controlled entity.²⁰

See also Treas. Reg. § 53.4958-3. The final regulations indicate that a facts-and-circumstances test must be applied to determine whether a person actually controls and manages a substantial portion of the activities, assets, income or expenses of the organization and not only the entire organization. One needs to examine the ultimate control in shared authority relationships. A person who exercises authority over a discrete and substantial department or division of the organization may be a disqualified person. Treas. Reg. § 53.4958-3(e)(2)(v).

b. Excess Benefit

Section 4958 defines an "excess benefit" as the extent to which the value of an economic benefit provided by a tax-exempt organization to a disqualified person exceeds the value received by the tax-exempt organization from the disqualified person. I.R.C. § 4958(c)(1); Treas. Reg. § 53.4958-1(b); Treas. Reg. § 53.4958-4(a)(1). Excess benefit transactions include arrangements that directly provide an excess benefit to a disqualified individual, as well as arrangements in which an excess benefit is achieved through indirect means. Treas. Reg. § 53.4958-4(a)(2). Thus, sanctions apply to excess benefits that are conferred through a controlled entity or through an intermediary. Treas. Reg. § 53.4958-4(a)(2).

c. Substantial Influence.

Certain persons are deemed to have "substantial influence" over an organization due to the "powers, responsibilities or interests" they hold. Treas. Reg. § 53.4958-3(c). Examples of such persons include voting members of the governing body, presidents,

¹⁹ Whether someone is a member of a "family" is determined within the meaning of I.R.C. § 4946(d), with the qualification that the term also includes brothers and sisters (including half-brothers and/or half-sisters) of the individual and their spouses. See I.R.C. § 4958(0)(4). A specific list of relatives who are considered family members is contained in Treas. Reg. § 53.4958-3.

²⁰ A 35-percent controlled entity is defined as a corporation in which disqualified persons own more than 35 percent of the total combined voting power, a partnership in which disqualified persons own more than 35 percent of the profits interest or a trust or estate in which disqualified persons own more than 35 percent of the beneficial interest. See I.R.C. §4958(f)(3)(A).

chief executive officers, chief operating officers, treasurers, and chief financial officers. Treas. Reg. § 53.4958-3(c)(1)-(3). In addition, a facts-and-circumstances test may indicate that other individuals also exert a "substantial influence" over the organization. Treas. Reg. § 53.4958-3(e). Factors that tend to suggest "substantial influence" include whether the person founded the organization or is a substantial contributor, whether his or her compensation is primarily based on revenues derived from activities that the person controls, whether he or she has authority to control or determine expenditures or compensation, whether he or she manages a substantial portion of the activities, assets, income or expenses of the organization. Treas. Reg. § 53.4958-3(e)(2). Other factors suggest that a person does not have substantial influence over an organization, including the fact that the person does not participate in management decisions. Treas. Reg. § 53.4958-3(e)(3). The final regulations also clarified that simply serving as a key advisor to a disqualified person is no longer to be considered a factor in determining the existence of "substantial influence."

d. Organization Manager.

The test for whether someone is an "organization manager" within the meaning of Section 4958 examines the functions which a person performs, rather than merely construing the title which he or she holds. Thus, the term comprehends not only officers, directors and trustees, but also any individual who has powers or responsibilities of an officer, director or a trustee. Treas. Reg. § 53.4958-1(d)(2)(i). A person may fall within the purview of this Section by virtue of his appointment as an officer, director or trustee under the governing documents of the organization or by virtue of the fact that he or she regularly exercises authority to make administrative decisions. Treas. Reg. § 53.4958-1(d)(2)(i).

2. Applicable Tax-Exempt Organizations.

An organization is subject to the regulations concerning excess benefit transactions if it is described in Section 501(c)(3) or Section 501(c)(4) (social welfare organization) and is exempt from tax under Section 501(a). Treas. Reg. § 53.4958-2(a)(1).

Certain organizations are exempt from the penalties concerning excess benefit transactions because of their structural characteristics. For example, Section 4958 does not apply to private foundations (as defined in Section 509(a)). Treas. Reg. § 53.4958-2(a)(2)(i). Likewise, the excess benefit penalties do not apply to a governmental unit or affiliate that is (1) exempt from taxation without regard to Section 501(a) or (2) exempt from filing an annual return under Section 6033 of the Code. Treas. Reg. § 53.4958-2(a)(2)(ii).

In some cases, the fact that a transaction is the subject of an approved exemption from the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 (ERISA) may also exempt an organization from the obstacles imposed by Section 4958. In these cases, the excess benefit transaction penalties do not apply to

transactions covered by a final individual prohibited transaction exemption issued by the Department of Labor. Treas. Reg. § 53.4958-4(a)(5). The Internal Revenue Service has determined that ERISA's requirements for a prohibited transaction are sufficiently similar to those of Section 4958 to insure that the goals of Section 4958 are implemented.

C. How to Establish Reasonable Compensation Under the New Law

The prohibitions against private inurement do not preclude the payment of reasonable compensation to people who would otherwise be disqualified persons. The key to structuring an appropriate compensation system is the ability to decipher the meaning of reasonableness.²¹

The final regulations provide a working definition of "reasonable compensation." In general, "the value of services is the amount that would ordinarily be paid for like services by like enterprises under like circumstances." Treas. Reg. § 53.4958-4(b)(1)(ii)(A).

Items to be included in this calculation include all economic benefits provided by the organization in exchange for the performance of services, including, but not limited to,

- cash and non-cash compensation (including salary, fees, bonuses, severance payments, deferred and non-cash compensation described in Treas. Reg. § 53.4958-1(e)(2)),
- unless excludable as *de minimis* fringe benefits under Section 132(a)(4) of the Internal Revenue Code, the payment of liability insurance premiums or payment of reimbursement by the organization of amounts owed under Section 4958 and other liabilities,
- all compensatory benefits (whether or not included in gross income), including payments to welfare benefit plans and taxable and nontaxable fringe benefits (other than described in Section 132), expense allowances, reimbursements (other than those that meet the requirements of Treas. Reg. § 1.62-2(c)), and the economic benefit of a below-market loan.

Treas. Reg. § 53.4958-4(b)(1)(ii)(B).

C. Revenue-Sharing²²

"Revenue-sharing transactions" permit incentive compensation to be determined in relationship to the revenues from an organization's activities.

²¹ For an excellent discussion of the issues that should be considered in determining reasonableness, see Jody Blazek, *Tax Planning and Compliance for Tax-Exempt Organizations* 489-93 (John Wiley & Sons, 3d. ed. 1999 & 2003 Supp.).

²² See 67 Fed. Reg. 3076, 3081-82 ("The final regulations continue to reserve the separate Section governing revenue-sharing transactions.")

The application of the intermediate sanctions to revenue-sharing has been and remains an unresolved issue in the final regulations. In Section 4958(c)(2), Congress directly addressed revenue-sharing transactions:

To the extent provided in regulations prescribed by the Secretary, the term "excess benefit transaction" includes any transaction in which the amount of any economic benefit provided to or for the use of a disqualified person is determined in whole or in part by the revenues of one or more activities of the organization but only if such transaction results in inurement not permitted under paragraph (3) or (4) of Section 501(c), as the case may be. In the case of any such transaction, the excess benefit shall be the amount of the inurement not so permitted.

[Emphasis added.]

The regulations which the Internal Revenue Service proposed in 1998 initially offered an extensive explanation of revenue-sharing arrangements. See Prop. Treas. Reg. § 53.4958-5, 63 Fed. Reg. 41486 (August 4, 1998). However, the temporary regulations issued in 2001 and the final regulations promulgated in 2002 eliminated the discussion of revenue-sharing that had appeared in the proposed regulations and reserved the topic for future consideration.

The proposed regulations, while no longer in force, will continue to be worthy of consideration until the topic of revenue sharing is again addressed in the form of regulations. The proposed regulations introduced the concept of proportionality. The proposed regulations suggested that when revenue-sharing produced an economic benefit that exceeded the fair market value of the services rendered by a disqualified person, the arrangement would constitute an excess benefit if the disqualified person received compensation that was not proportional to the benefits contributed to the organization. In particular, Prop. Treas. Reg. § 53.4958-5(a) provided that

*A revenue sharing transaction may constitute an excess benefit transaction regardless of whether the economic benefit provided to the disqualified person exceeds the fair market value of the consideration provided in return if, at any point, it permits a disqualified person to receive additional compensation *without providing proportional benefits that contribute to the organization's accomplishment of its main purpose.* [Emphasis added.]*

This language prompted speculation concerning whether a revenue-sharing transaction has two separate but related tests: (1) an economic benefit in excess of fair market value; and (2) compensation that is not proportional to the benefits that the organization received.

The proposed regulations explicated this general statement by providing several examples. Each of the examples illustrates the Internal Revenue Service's understanding of the relationship between compensation and the proportional return of benefits to the organization.

D. Reaching the Rebuttable Presumption of Reasonableness

If the organization follows the criteria set by the tax regulations, the resulting compensation is presumed to be reasonable. This presumption can be rebutted by the I.R.S. The regulations concerning the rebuttable presumption of reasonableness require the appropriate decision-maker (usually the Board of Directors or a designated committee)²³ to observe three critical rules. The committee must (a) be composed entirely of individuals who do not have a conflict of interest with regard to the compensation arrangement, (b) rely upon appropriate data concerning comparability prior to rendering its decision and (c) have adequately documented the basis for its determination. Treas. Reg. § 53.4958-6.

Assuming that a tax-exempt organization is able to demonstrate that it observed these requirements in determining the compensation of a disqualified person, the burden of proving that the transaction is unreasonable shifts to the Internal Revenue Service. The Internal Revenue Service may rebut this presumption "only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body." Treas. Reg. § 53.4958-6(b).

The final regulations provide special rules for the application of the presumption to non-fixed payments. Treas. Reg. § 53.4958-6(d). A fixed payment an amount specified in a contract or determined by a fixed formula. Treas. Reg. §§ 53.4958-4(a)(3)(ii)A.

- The rebuttable presumption only becomes effective with respect to non-fixed payments after the exact amount of the payment is determined or a fixed formula for its calculation is specified and the additional requirements of Section 53.4958-6(a) (concerning the approval of arrangement by committee whose members do not have a conflict of interest; and reliance on appropriate comparability data and adequate documentation). Treas. Reg. § 53.4958-6(d)(1).
- Certain non-fixed payments that are subject to a cap may rely on the presumption at the time the contract is entered into if the authorized decision-making body obtains comparability data with respect to the cap and satisfies all other relevant requirements concerning the establishment of the rebuttable presumption. Treas. Reg. § 53.4958-6(d)(2).

²³ The preamble to the final regulations clarifies that a single authorized individual may serve as the committee of the governing body or the delegate of the governing body with respect to this decision, subject to the requirements of State law. See 67 Fed. Reg. at 3082.

E. Appropriate Comparability Data

The decision-maker's reliance on "appropriate data" is critical to establishing the rebuttable presumption of reasonableness. The general test for the appropriateness of the data is whether, "given the knowledge and expertise of [the decision maker] antecedent its members, it has information sufficient to determine whether, under the standards set forth in § 53.4958-4(b), the compensation arrangement in its entirety is reasonable." Treas. Reg. § 53.4958-6(c)(2)(i). Such data may include compensation levels paid by similarly situated organizations for similar positions, the availability of similar services in the geographic locale, current compensation surveys compiled by independent firms, and actual written offers to the disqualified person from similar institutions. Small organizations (defined as those with annual gross receipts, including contributions, of less than \$1 million) may satisfy the "appropriate data" requirement by obtaining data on compensation paid by three similarly situated organizations for similar services..." Treas. Reg. § 53.4958-6(c)(2)(ii).

F. What is Adequate Documentation?

A decision is considered to be adequately documented when the written or electronic records of the authorized decision-maker note:

- The terms of the transaction that were approved and the date of the approval;
- The members of the authorized decision-maker who were present during debate on the transaction and those who voted for it;
- The comparability data that was obtained and relied upon by the authorized body and the manner in which it was obtained; and
- Any actions taken with respect to the transaction by any person who would otherwise be a member of the authorized body but who had a conflict of interest with respect to the transaction. Treas. Reg. § 53.4958-6(c)(2)(ii).

G. Persons Subject to Penalties

The new intermediate sanctions target a broad array of individuals who face stiff penalties in the event of their participation in an excess benefit transaction. The first and most obvious person to be subject to a penalty is the disqualified person who engages in the transaction. Section 4958(a)(1) imposes a 25 percent excise tax on any disqualified person who engages in an "excess benefit transaction" in violation of the prohibition against private inurement. See also Treas. Reg. § 53.4958-1(a). The statute assesses a more severe penalty against any disqualified person who fails to correct²⁴ an excess

²⁴ Section 4958(f)(6) provides:

The term "correction" and "correct" mean, with respect to any excess benefit transaction, undoing the excess benefit to the extent possible, and taking any additional measures necessary to place the organization in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.

benefit transaction within the taxable period;²⁵ in such a case, the additional tax equals 200 percent of the excess benefit. See I.R.C. § 4958(b); Treas. Reg. § 53.4958-1(a).

In enacting the excess benefit transaction penalties, Congress indicated the important role of organization managers in policing potential excess benefit transactions. Section 4958(a)(2) imposes an additional tax of 10 percent of the excess benefit on the any organization manager who knowingly participates in such a transaction unless his or her participation was not willful and was due to reasonable cause. Treas. Reg. § 53.4958-1(d)(1). The final regulations are ambitious in their efforts to encourage organization managers to be vigilant. An organization manager "participates" in a transaction not only by his affirmative approval of such a transaction but also by "silence or inaction...where the manager is under a duty to speak or act." Treas. Reg. § 53.4958-1(d)(3). Although the regulations do not equate constructive and actual knowledge, the regulations do impute knowledge of the transaction in a fairly strict manner. Under Treas. Reg. § 53.4958-1(d)(4)(i)(A)-(C), a manager "knows" of an excess benefit transactions if he or she

- (a) has actual knowledge of sufficient facts so that, based solely upon those facts, such transaction would be an excess benefit transaction;
- (b) is aware that such a transaction ... might violate ...Federal tax law governing excess benefit transactions; and
- (c) negligently fails to make reasonable attempts to ascertain whether the transaction is an excess benefit transaction...

How might an organization manager limit the potential for liability under this stringent standard? The final regulations suggest several areas that may prove useful to a practitioner who is facing this question.

- The regulations do allow some assurance to an organization manager who "oppose[s] the transaction in a manner consistent with the fulfillment of the manager's responsibilities to the applicable tax-exempt organization." Treas. Reg. § 53.4958-1(d)(3). A person who fulfills these conditions will not be considered to have "participated" in the excess benefit transaction. Id.
- The regulations differentiate between "knowing" and "having reason to know." Treas. Reg. § 53.4958-1(d)(4)(ii). Knowledge is not imputed to

This provision is supplemented by regulations at Treas. Reg. § 53.4958-7.

²⁵ Section 4958(f)(5) further defines a "taxable period" as the period beginning with the date on which the transaction occurs and ending on the earliest of the date on which a deficiency notice is mailed or the date on which the tax excise tax is assessed.

an organization manager who participates in a transaction due to his or her reliance on "a reasoned written opinion" of "an appropriate professional with respect to elements of the transaction within the professional's area of expertise." Treas. Reg. § 53.4958-1(d)(4)(iii). The regulations detail stringent requirements for determining whether such an opinion has been given. Treas. Reg. § 53.4958-1(d)(4)(iii)(A)-(C). Reliance on an opinion that meets these qualifications serves as a buffer to an organization manager who has sought advice on the status of a transaction that later turns out to be suspect. Treas. Reg. § 53.4958-1(d)(4)(iii).

- Participation in a transaction is "ordinarily not considered knowing ... if the appropriate authorized body has met the requirements of § 53.4958-6(a)." Treas. Reg. § 53.4958-1(d)(4)(iv). These requirements detail the conditions under which the organization meets the rebuttable presumption that the transaction is not an excess benefit transaction. Treas. Reg. § 53.4958-6.

The excise tax imposed by Treas. Reg. § 53.4958-1(d)(1) does not apply to a manager whose participation was not willful and was due to reasonable cause. "Willful" participation is defined as "voluntary, conscious, and intentional." Treas. Reg. § 53.4958-1(d)(5). Participation is not willful if the organization manager "does not know that the transaction ... is an excess benefit transaction." Treas. Reg. § 53.4958-1(d)(5). Participation may be attributed to reasonable cause "if the manager has exercised responsibility on behalf of the organization with ordinary business care and prudence." Treas. Reg. § 53.4958-1(d)(6).

EXHIBIT 1-B

Examples Excerpted from the Treasury Regulations

Treas. Reg. § 53.4958-3(g)

Example 1. N, an artist by profession, works part-time at R, a local museum. In the first taxable year in which R employs N, R pays N a salary and provides no additional benefits to N except for free admission to the museum, a benefit R provides to all of its employees and volunteers. The total economic benefits N receives from R during the taxable year are less than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i). The part-time job constitutes N's only relationship with R. N is not related to any other disqualified person with respect to R. N is deemed not to be in a position to exercise substantial influence over the affairs of R. Therefore, N is not a disqualified person with respect to R in that year.

Example 2. The facts are the same as in Example 1, except that in addition to the salary that R pays N for N's services during the taxable year, R also purchases one of N's paintings for \$x. The total of N's salary plus \$x exceeds the amount referenced for highly compensated employees in section 414(q)(1)(B)(i). Consequently, whether N is in a position to exercise substantial influence over the affairs of R for that taxable year depends upon all of the relevant facts and circumstances.

Example 3. Q is a member of K, a section 501(c)(3) organization with a broad-based public membership. Members of K are entitled to vote only with respect to the annual election of directors and the approval of major organizational transactions such as a merger or dissolution. Q is not related to any other disqualified person of K. Q has no other relationship to K besides being a member of K and occasionally making modest donations to K. Whether Q is a disqualified person is determined by all relevant facts and circumstances. Q's voting rights, which are the same as granted to all members of K, do not place Q in a position to exercise substantial influence over K. Under these facts and circumstances, Q is not a disqualified person with respect to K.

Example 4. E is the headmaster of Z, a school that is an applicable tax-exempt organization for purposes of section 4958. E reports to Z's board of trustees and has ultimate responsibility for supervising Z's day-to-day operations. For example, E can hire faculty members and staff, make changes to the school's curriculum and discipline students without specific board approval. Because E has ultimate responsibility for supervising the operation of Z, E is in a position to exercise substantial influence over the affairs of Z. Therefore, E is a disqualified person with respect to Z.

Example 5. Y is an applicable tax-exempt organization for purposes of section 4958 that decides to use bingo games as a method of generating revenue. Y enters into a contract with B, a company that operates bingo games. Under the contract, B manages the promotion and operation of the bingo activity, provides all necessary staff, equipment, and services, and pays Y q percent of the revenue from this activity. B retains the balance of the proceeds. Y provides no goods or services in connection with the bingo

operation other than the use of its hall for the bingo games. The annual gross revenue earned from the bingo games represents more than half of Y's total annual revenue. B's compensation is primarily based on revenues from an activity B controls. B also manages a discrete activity of Y that represents a substantial portion of Y's income compared to the organization as a whole. Under these facts and circumstances, B is in a position to exercise substantial influence over the affairs of Y. Therefore, B is a disqualified person with respect to Y.

Example 6. The facts are the same as in Example 5, with the additional fact that P owns a majority of the stock of B and is actively involved in managing B. Because P owns a controlling interest (measured by either vote or value) in and actively manages B, P is also in a position to exercise substantial influence over the affairs of Y. Therefore, under these facts and circumstances, P is a disqualified person with respect to Y.

Example 7. A, an applicable tax-exempt organization for purposes of section 4958, owns and operates one acute care hospital. B, a for-profit corporation, owns and operates a number of hospitals. A and B form C, a limited liability company. In exchange for proportional ownership interests, A contributes its hospital, and B contributes other assets, to C. All of A's assets then consist of its membership interest in C. A continues to be operated for exempt purposes based almost exclusively on the activities it conducts through C. C enters into a management agreement with a management company, M, to provide day to day management services to C. Subject to supervision by C's board, M is given broad discretion to manage C's day to day operation and has ultimate responsibility for supervising the management of the hospital. Because M has ultimate responsibility for supervising the management of the hospital operated by C, A's ownership interest in C is its primary asset, and C's activities form the basis for A's continued exemption as an organization described in section 501(c)(3), M is in a position to exercise substantial influence over the affairs of A. Therefore, M is a disqualified person with respect to A.

Example 8. T is a large university and an applicable tax-exempt organization for purposes of section 4958. L is the dean of the College of Law of T, a substantial source of revenue for T, including contributions from alumni and foundations. L is not related to any other disqualified person of T. L does not serve on T's governing body or have ultimate responsibility for managing the university as whole. However, as dean of the College of Law, L plays a key role in faculty hiring and determines a substantial portion of the capital expenditures and operating budget of the College of Law. L's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. L's management of a discrete segment of T that represents a substantial portion of the income of T (as compared to T as a whole) places L in a position to exercise substantial influence over the affairs of T. Under these facts and circumstances L is a disqualified person with respect to T.

Example 9. S chairs a small academic department in the College of Arts and Sciences of the same university T described in Example 8. S is not related to any other disqualified person of T. S does not serve on T's governing body or as an officer of T. As department chair, S supervises faculty in the department, approves the course curriculum, and

oversees the operating budget for the department. S's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. Even though S manages the department, that department does not represent a substantial portion of T's activities, assets, income, expenses, or operating budget. Therefore, S does not participate in any management decisions affecting either T as a whole, or a discrete segment or activity of T that represents a substantial portion of its activities, assets, income, or expenses. Under these facts and circumstances, S does not have substantial influence over the affairs of T, and therefore S is not a disqualified person with respect to T.

Example 10. U is a large acute-care hospital that is an applicable tax-exempt organization for purposes of section 4958. U employs X as a radiologist. X gives instructions to staff with respect to the radiology work X conducts, but X does not supervise other U employees or manage any substantial part of U's operations. X's compensation is primarily in the form of a fixed salary. In addition, X is eligible to receive an incentive award based on revenues of the radiology department. X's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. X is not related to any other disqualified person of U. X does not serve on U's governing body or as an officer of U. Although U participates in a provider-sponsored organization (as defined in section 1855(e) of the Social Security Act), X does not have a material financial interest in that organization. X does not receive compensation primarily based on revenues derived from activities of U that X controls. X does not participate in any management decisions affecting either U as a whole or a discrete segment of U that represents a substantial portion of its activities, assets, income, or expenses. Under these facts and circumstances, X does not have substantial influence over the affairs of U, and therefore X is not a disqualified person with respect to U.

Example 11. W is a cardiologist and head of the cardiology department of the same hospital U described in Example 10. The cardiology department is a major source of patients admitted to U and consequently represents a substantial portion of U's income, as compared to U as a whole. W does not serve on U's governing board or as an officer of U. W does not have a material financial interest in the provider-sponsored organization (as defined in section 1855(e) of the Social Security Act) in which U participates. W receives a salary and retirement and welfare benefits fixed by a three-year renewable employment contract with U. W's compensation is greater than the amount referenced for a highly compensated employee in section 414(q)(1)(B)(i) in the year benefits are provided. As department head, W manages the cardiology department and has authority to allocate the budget for that department, which includes authority to distribute incentive bonuses among cardiologists according to criteria that W has authority to set. W's management of a discrete segment of U that represents a substantial portion of its income and activities (as compared to U as a whole) places W in a position to exercise substantial influence over the affairs of U. Under these facts and circumstances, W is a disqualified person with respect to U.

Example 12. M is a museum that is an applicable tax-exempt organization for purposes of section 4958. D provides accounting services and tax advice to M as a contractor in return for a fee. D has no other relationship with M and is not related to any disqualified person of M. D does not provide professional advice with respect to any transaction from which D might economically benefit either directly or indirectly (aside from fees received for the professional advice rendered). Because D's sole relationship to M is providing professional advice (without having decision-making authority) with respect to transactions from which D will not economically benefit either directly or indirectly (aside from customary fees received for the professional advice rendered), under these facts and circumstances, D is not a disqualified person with respect to M.

Example 13. F is a repertory theater company that is an applicable tax-exempt organization for purposes of section 4958. F holds a fund-raising campaign to pay for the construction of a new theater. J is a regular subscriber to F's productions who has made modest gifts to F in the past. J has no relationship to F other than as a subscriber and contributor. F solicits contributions as part of a broad public campaign intended to attract a large number of donors, including a substantial number of donors making large gifts. In its solicitations for contributions, F promises to invite all contributors giving \$z or more to a special opening production and party held at the new theater. These contributors are also given a special number to call in F's office to reserve tickets for performances, make ticket exchanges, and make other special arrangements for their convenience. J makes a contribution of \$z to F, which makes J a substantial contributor within the meaning of section 507(d)(2)(A), taking into account only contributions received by F during its current and the four preceding taxable years. J receives the benefits described in F's solicitation. Because F offers the same benefit to all donors of \$z or more, the preferential treatment that J receives does not indicate that J is in a position to exercise substantial influence over the affairs of the organization. Therefore, under these facts and circumstances, J is not a disqualified person with respect to F.

Prop. Treas. Reg. 53-4958-5(d), Examples 1-3
(Note: This Proposed Regulation is no longer effective.)

Example 1. A is the manager of the investment portfolio of M, an applicable tax-exempt organization for purposes of section 4958. A and several other professional investment managers work exclusively for M in an office in M's building. A's compensation consists of a flat base annual salary, health insurance, eligibility to participate in a retirement plan, and a bonus that is equal to a percentage of any increase in the value of M's portfolio over the year (net of expenses for investment management other than the in-house managers' compensation). The revenue-based portion of A's compensation gives A an incentive to provide the highest quality service in order to maximize benefits and minimize expenses to M. A has a measure of control over the activities generating the revenues on which his bonus is based, but A can increase his own compensation only if M also receives a proportional benefit. Under these facts and circumstances, the payment to A of the bonus described above does not constitute an excess benefit transaction under the rules of this section.

Example 2. L, an applicable tax-exempt organization for purposes of section 4958, enters into a contract with H, a company who manages charitable gaming activities for public charities. As a result of the contractual relationship, H becomes a disqualified person with respect to any transaction involving L that provides economic benefits to H directly or indirectly. Under the contract, H agrees to provide all of the staff and equipment necessary to carry out charitable gaming operations on behalf of L, and to pay L z percent of the net profits, which are calculated as the gross revenue less rental for the equipment, wages for the staff, prizes for the winners, and other specified operating expenses. H retains the balance of the proceeds after expenses and after paying L its z percent of the net profits. As manager, H controls the activities generating the revenue on which its compensation is based. In addition, because H owns the equipment and employs the staff needed to operate the charitable gaming activities, H controls what L is charged, including the profit H makes above the cost of these items. Therefore, H can also control the net revenues relative to the gross revenues from the gaming activity. The structure of the compensation H receives for its services does not provide H with an appropriate incentive to maximize benefits and minimize costs to L. H benefits whether expenses are high and net revenues are low or expenses are low and net revenues are high. By contrast, L suffers if expenses for the charitable gaming operation are high and net revenues are low. All of the gross revenues generated by the charitable gaming operation belong to L. The arrangement between H and L allows a portion of those revenues to inure to H. Therefore, this arrangement results in the inurement of L's net earnings to the benefit of H, and the entire amount paid to H under this arrangement constitutes an excess benefit under the rules of this section.

Example 3. R, a professor and faculty member at S, a university that is an applicable tax-exempt organization for purposes of section 4958, is the principal investigator in charge of certain scientific research at S. The research produces an invention. In accordance with S's agreement with its faculty, S owns the invention. R assists S in preparing a patent application. S receives a patent for R's invention, which S owns. Also in

accordance with S's agreement with its faculty, S grants R the right to receive v percent of S's royalties on the patent, payable semi-annually. R also receives an annual compensation package of salary and benefits. The availability of revenue-based compensation under these circumstances does not give R any incentive or opportunity to act contrary to S's interests in accomplishing its exempt purpose. R receives the revenue-based compensation, i.e., the percentage of royalties, as an incentive and a reward for producing work of especially high quality. In addition, any time R benefits by receiving royalties, S benefits as well and to a proportionate degree. Finally, because the patent belongs to S, R has no control over how the patent is used nor the stream of revenue it generates. Under these facts and circumstances, S's payment of revenue-based compensation to R does not constitute an excess benefit transaction under the rules of this section.

Treas. Reg. § 53.4958-6(c)(2)(iv), Examples 1-5

Example 1. Z is a university that is an applicable tax-exempt organization for purposes of section 4958. Z is negotiating a new contract with Q, its president, because the old contract will expire at the end of the year. In setting Q's compensation for its president at \$600x per annum, the executive committee of the Board of Trustees relies solely on a national survey of compensation for university presidents that indicates university presidents receive annual compensation in the range of \$100x to \$700x; this survey does not divide its data by any criteria, such as the number of students served by the institution, annual revenues, academic ranking, or geographic location. Although many members of the executive committee have significant business experience, none of the members has any particular expertise in higher education compensation matters. Given the failure of the survey to provide information specific to universities comparable to Z, and because no other information was presented, the executive committee's decision with respect to Q's compensation was not based upon appropriate data as to comparability.

Example 2. The facts are the same as Example 1, except that the national compensation survey divides the data regarding compensation for university presidents into categories based on various university-specific factors, including the size of the institution (in terms of the number of students it serves and the amount of its revenues) and geographic area. The survey data shows that university presidents at institutions comparable to and in the same geographic area as Z receive annual compensation in the range of \$200x to \$300x. The executive committee of the Board of Trustees of Z relies on the survey data and its evaluation of Q's many years of service as a tenured professor and high-ranking university official at Z in setting Q's compensation at \$275x annually. The data relied upon by the executive committee constitutes appropriate data as to comparability.

Example 3. X is a tax-exempt hospital that is an applicable tax-exempt organization for purposes of section 4958. Before renewing the contracts of X's chief executive officer and chief financial officer, X's governing board commissioned a customized compensation survey from an independent firm that specializes in consulting on issues related to executive placement and compensation. The survey covered executives with comparable responsibilities at a significant number of taxable and tax-exempt hospitals. The survey data are sorted by a number of different variables, including the size of the hospitals and the nature of the services they provide, the level of experience and specific responsibilities of the executives, and the composition of the annual compensation packages. The board members were provided with the survey results, a detailed written analysis comparing the hospital's executives to those covered by the survey, and an opportunity to ask questions of a member of the firm that prepared the survey. The survey, as prepared and presented to X's board, constitutes appropriate data as to comparability.

Example 4. The facts are the same as Example 3, except that one year later, X is negotiating a new contract with its chief executive officer. The governing board of X obtains information indicating that the relevant market conditions have not changed materially, and possesses no other information indicating that the results of the prior

year's survey are no longer valid. Therefore, X may continue to rely on the independent compensation survey prepared for the prior year in setting annual compensation under the new contract.

Example 5. W is a local repertory theater and an applicable tax-exempt organization for purposes of section 4958. W has had annual gross receipts ranging from \$400,000 to \$800,000 over its past three taxable years. In determining the next year's compensation for W's artistic director, the board of directors of W relies on data compiled from a telephone survey of three other unrelated performing arts organizations of similar size in similar communities. A member of the board drafts a brief written summary of the annual compensation information obtained from this informal survey. The annual compensation information obtained in the telephone survey is appropriate data as to comparability.

Exhibit 1-C

Excerpts from Catholic Social Thought Texts

Except as noted, the excerpts from the encyclicals in this Appendix are taken from the version of the encyclicals that appear in O'Brien and Shannon's *Catholic Social Thought: The Documentary Heritage*.²⁶

Leo XIII, *On the Condition of Labor* (1891)

¶5: “And on this account—namely, that man alone among animals possesses reason—it must be within his right to have things not merely for temporary and momentary use, as other living beings have them, but in stable and permanent possession; he must have not only things which perish in the using, but also those which, though used, remain for use in the future.”²⁷

¶9: “That right of property, therefore, which has been proved to belong naturally to individual persons, must also belong to a man in his capacity of head of a family; nay such a person must possess this right so much the more clearly in proportion as his position multiplies his duties.”²⁸

¶10 “For it is a most sacred law of nature that a father must provide food and all necessities for those whom he has begotten, and, similarly, nature dictates that a man's children, who carry on, as it were, and continue his own personality, should be provided by him with all that is needful to enable them honorably to keep themselves from want and misery in the uncertainties of this mortal life.”²⁹

¶16 “Religion teaches the rich man and the employer that their work people are not their slaves; that they must respect in every man his dignity as a man and as a Christian; that labor is nothing to be ashamed of, if we listen to right reason and to Christian philosophy, but is an honorable employment, enabling a man to sustain his life in an upright and creditable way; and that it is shameful and inhuman to treat men like chattels to make money by, or to look upon them merely as so much muscle or physical power. Thus, again, religion teaches that, as among the workmen's concerns are religion herself and things spiritual and mental, the employer is bound to see that he has time for the duties of piety; that he be not exposed to corrupting influences and dangerous occasions; and that he be not led away to neglect his home and family or to squander his wages. Then, again, the employer must never tax his work-people beyond their strength, nor employ them in work unsuited to their sex or age.”³⁰

²⁶ David J. O'Brien & Thomas A. Shannon, *CATHOLIC SOCIAL THOUGHT – THE DOCUMENTARY HERITAGE* (Orbis Books 1992).

²⁷ *On the Condition of Labor* ¶5.

²⁸ *On the Condition of Labor* ¶9.

²⁹ *On the Condition of Labor* ¶10.

³⁰ *On the Condition of Labor* ¶16.

¶17 “His great and principal obligation is to give to every one that which is just. Doubtless before we can decide whether wages are adequate, many things have to be considered; but rich men and masters should remember this—that to exercise pressure for the sake of gain, upon the indigent and destitute, and to make one’s profit out of the need of another is condemned by all laws, human and divine. To defraud anyone of wages that are his due is a crime which cries to the avenging anger of heaven.”³¹

¶17 “Finally, the rich must religiously refrain from cutting down the workman’s earnings, either by force, fraud, or by usurious dealing; and with the more reason because the poor man is weak and unprotected, and because his slender means should be sacred in proportion to their scantiness.”³²

¶ 29 “The richer population have many ways of protecting themselves, and stand less in need of help from the State; those who are badly off have no resources of their own to fall back upon, and must chiefly rely upon the assistance of the State. And it is for this reason that wage earners, who are, undoubtedly, among the weak and necessitous, should be specially cared for and protected by the commonwealth. ... It must be borne in mind that the chief thing to be secured is the safeguarding, by legal enactment and policy, of private property. Most of all it is essential in these times of covetous greed, to keep the multitude within the line of duty, for if all may justly strive to better their condition, yet neither justice nor the common good allows anyone to seize that which belongs to another, or, under the pretext of futile and ridiculous equality, to lay hands on other people’s fortunes. It is most true that by far the larger part of the people who work prefer to improve themselves by honest labor rather than by doing wrong to others. But there are not a few who are imbued with bad principles and are anxious for revolutionary change, and whose great purpose is to stir up tumult and bring about a policy of violence. The authority of the State should intervene to put restraint upon these disturbers...”³³

¶ 34 “We now approach a subject of very great importance and one on which, if extremes are to be avoided, right ideas are absolutely necessary. Wages, we are told, are fixed by free consent; and, therefore, the employer when he pays what was agreed upon has done his part, and is not called upon for anything further. The only way, it is said, in which injustice could happen would be if the master refused to pay the whole of the wages, or the workman would not complete the work undertaken; when this happens, the State should intervene to see that each obtains his own, but not under any other circumstances.”³⁴

¶ 45 “Let it be granted, then, that, as a rule, workman and employer should make free agreements, and in particular should freely agree as to wages; nevertheless, there is a dictate of nature more imperious and more ancient than any bargain between man and

³¹ *On the Condition of Labor* ¶17.

³² *Id.*

³³ *Id.* at ¶ 37.

³⁴ *On the Condition of Labor* ¶34.

man, that the remuneration must be enough to support the wage earner in reasonable and frugal comfort.”³⁵

Pius XI, *After Forty Years* (1931)

After Forty Years celebrates the fortieth anniversary of *On the Condition of Labor*. After restating the principles of *On the Condition of Labor*, Pius meditates upon the meaning of “social justice” in the modern economy.³⁶ Pius suggests that it would be unfair to say that contracting for wages was per se unjust. Instead, the wage contract should be modified by a contract of partnership, so that workers and executives become partners in ownership or participate in profits.³⁷ *After Forty Years* states that three factors must be considered in judging whether a wage is just. First, the wage should be “adequate to meet ordinary domestic needs” of the working man and his family.³⁸ Second, the financial viability of the business itself is a valid topic for consideration.³⁹ Third, the just wage must also reflect the requirements of the common good.⁴⁰

John XXIII, *Christianity and Social Progress* (1961)

¶ 71 “Wherefore, we judge it to be our duty to reaffirm once again that just as remuneration for work cannot be left entirely to unregulated competition, neither may it be decided arbitrarily at the will of the more powerful. Rather, in this matter, the norms of justice and equity should be strictly observed. This requires that workers receive a wage sufficient to lead a life worthy of man and to fulfill family responsibilities properly. But in determining what constitutes an appropriate wage, the following must necessarily be taken into account: first of all, the contribution of individuals to the economic effort; the economic state of the enterprises within which they work; the requirements of each community, especially as regards overall employment; finally, what concerns the common good of all peoples, namely, of the various States associated among themselves but differing in character and extent.”⁴¹

John Paul II, *On Human Work* (1981)

¶ 19.6 “Besides wages, various social benefits intended to ensure the life and health of workers and their families play a part here. The expenses involved in health care, especially in the case of accidents at work, demand that medical assistance should be easily available for workers and that as far as possible it should be cheap or even free of charge. ... A third sector concerns the right to a pension and to insurance for old age and in case of accidents at work. Within the sphere of these principal rights there develops a whole system of particular rights which, together with remuneration for work, determine

³⁵ *On the Condition of Labor* ¶ 45.

³⁶ *After Forty Years* ¶ 57.

³⁷ *After Forty Years* ¶ 64 et seq.

³⁸ *After Forty Years* ¶ 71 .

³⁹ *After Forty Years* ¶ 72.

⁴⁰ *After Forty Years* ¶ 74.

⁴¹ *Christianity and Social Progress* ¶ 71.

the correct relationship between worker and employer. Among these rights there should never be overlooked the right to a working environment and to manufacturing processes which are not harmful to the workers' physical health or to their moral integrity."⁴²

U.S. Catholic Bishops, Economic Justice for All (1986)

¶ “Persons in management face many hard choices each day, choices on which the well-being of many others depends. Commitment to the public good and not simply the private good of their firms is at the heart of what it means to call their work a vocation and not simply a career or a job.”⁴³

National Conference of Catholic Bishops / United States Catholic Conference, Working Paper, *A Fair and Just Workplace: Principles and Practices for Catholic Health Care*⁴⁴

[These principles and practices are easily applicable to a social service agency.]

“Among the elements of a just and fair workplace are: fair wages, adequate benefits, safe and decent working conditions, and the right to participate in decisions which affect one's work, as well as opportunities for advancement, learning and growth.”

The working paper proposed several specific questions with regard to whether a Catholic health system meets the requirements of the Church's social teachings:

- “Do the lowest paid workers receive wages sufficient to sustain themselves and their families?”
- “Is health care insurance provided or are wages sufficient for a worker to both sustain a family and purchase health care insurance?”
- “Are work hours flexible so as to permit adequate rest, leisure time, educational opportunities, and quality family time?”
- “What is the purpose of part-time or contract positions – to advance the mission of the institution and meet the needs of the workers or to avoid paying benefits?”

⁴² *On Human Work* ¶ 19.6

⁴³ *Economic Justice for All* ¶ 111 .

⁴⁴ www.usccb.org/sdwp/national/workplace.htm (May 30, 2003).

Vatican II, Pastoral Constitution on the Church in the Modern World (Gaudium et Spes) (1965)

These excerpts are taken from *The Basic Sixteen Documents: Vatican II, Constitutions, Decrees, Declarations* (Austin Flannery, O.P., ed., Costello Publishing Company, Inc. 1996).

Such rapid and uneven change, coupled with an increasingly keener awareness of existing inequalities make for the creation and aggravation of differences and imbalances.

On the personal level, there often arises an imbalance between a modern practical outlook and a theoretical way of thinking which fails to master and synthesize the sum total of ideas. Another imbalance occurs between concern for practical effectiveness and the demands of moral conscience; yet another occurs between life in society and the individual's need for reflection and contemplation. A final imbalance takes the form of conflict between the specialization of human activity and a global view of reality. (par. # 8, p.169)

In the sphere of economics and social life, too, the dignity and vocation of the human person as well as the welfare of society as a whole have to be respected and fostered; for people are the source, the focus and the aim of all economic and social life.

Like all other areas of social life, the economy of today is marked by humanity's growing domination over nature, by closer and more developed relationships between individuals, groups and peoples, and by the frequency of state intervention. At the same time increased efficiency in production and improved methods of distribution, of productivity and services have rendered the economy an instrument capable of meeting the increasing needs of the human family.

But the picture is not without its disturbing elements. Many people, especially in economically advanced areas, seem to be dominated by economics; almost all of their personal and social lives are permeated with a kind of economic mentality, and this is true of nations that favor a collective as well as of other nations. At the very time when economic progress, provided it is directed and organized in a reasonable and human way, could do much to reduce social inequalities, it serves too often only to aggravate them; in some places even leads to a decline in the situation of the underprivileged and to contempt for the poor. ... considerable reform in economic and social life is required along with a universal change of mentality and attitude. It was for this reason that the church in the course of centuries has worked out in the light of the Gospel principles of justice and equity demanded by right reason for individual and social life and also for international relations (par # 63, pp. 241-243).

The ultimate and basic purpose of economic production does not consist of merely producing goods, nor in profit or prestige; economic production is meant to be at the service of humanity in its totality, taking into account people's material needs and the requirements of their intellectual, moral, spiritual, and religious life; it is intended to benefit all individuals and groups of people of whatever race or from whatever part of the world (par #64, p. 243).

Remuneration for work should guarantee to individuals the capacity to provide a dignified livelihood for themselves and their family on the material social, cultural and spiritual level corresponding to their roles and productivity ,having regard to the relevant economic factors in their employment and the common good (par #67, p.246).

EXHIBIT 2

Discussion Questions

These questions may be selected to fit the level of the student and the professional school in which the course is offered.

1. What is social entrepreneurship? Do you think that Isabelle Intellectuelle's article effectively captures the essence of social entrepreneurship? What other factors would you consider to be essential for identifying a successful social entrepreneur? What values do these factors reflect?
2. Is Judy correct in identifying herself as a social entrepreneur? Is Judy's plan a successful example of social entrepreneurship as you understand it? What values (personal, corporate and other) are at work in Judy's plan?
3. What is the theoretical purpose of the nonprofit sector? What purpose should it serve? What purpose does Saint Hedwig's serve? Do you think that Article III of the Articles of Incorporation does a good job of describing this purpose? The language in Article III directly tracks the language that the Internal Revenue Service suggests in I.R.S. Pub. 557 (Rev. May 2003). Why did the drafters of the Articles not amplify this language with a more specific description of Saint Hedwig's purposes? Would the Board's job be easier if they had?
4. Is it fair to say that Saint Hedwig's has a "Catholic identity"? What factors suggest that it does or does not? How should the Board's decisions reflect Catholic teaching or thinking in its deliberations? How does Judy's proposal reflect an understanding of these principles?
5. What aspects of Catholic social thought are relevant to compensation planning? Can a Catholic corporation observe Catholic social thought and still offer a revenue sharing incentive plan? Does Catholic social thought impede a Catholic organization from competing in the marketplace?
6. How can one be sure that one is correctly applying Catholic social thought to a business problem in the 21st century United States?
7. Assume, for purposes of this question, that in fact the Center has no formal affiliation with the Roman Catholic Church and is simply a non-profit organization that was founded and administered by lay people who have a personal commitment to the values of Catholic social thought. How would this change your answers concerning the Catholic identity of the organization? How would this change your answers concerning the relevance of Catholic social thought? Does Catholic social teaching have any relevance to an organization that is not affiliated with the Roman Catholic Church?
8. What is the purpose of revenue-sharing?

9. Is Marvin Motivator correct in asserting that “incentivizing equals maximizing”? Is there a legal or ethical danger to tax-exempt nonprofit corporations that adopt Marvin’s philosophy?
10. Is it legally permissible under Section 4958 for Judy and her fellow executives to receive a percentage of revenue sharing? Why or why not? Examine the examples provided by the Internal Revenue Service in the Proposed Regulations. Does one of these situations resemble Judy’s proposal? What conclusions can you make regarding this? *[Appropriate for law students.]*
11. Based on your understanding of the law and the facts, draft a “short answer” to complete the opinion offered by Dorcas Shelby. *[Appropriate for law students.]*
12. Assume that revenue-sharing were legally permissible, are there other reasons to reject Judy’s plan?
13. What procedural safeguards should the Board observe? Can Judy, Charlie and the other members be involved in these decisions?
14. Draft a resolution that the Committee can present to the Board regarding this matter.

INSTRUCTOR'S NOTE

- *The following suggests some points that the students should raise in their answers to Discussion Question 11.*
- Practical Considerations Concerning the Testing of Reasonableness
 - The Board should carefully choose its comparability data. A rule of thumb for reasonableness of total compensation is whether the compensation falls within a 25-75% of range of the comparability data for executive compensation in comparable organizations.⁴⁵
 - The Board should examine the compensation that may be generated by the proposed arrangement to benchmarks which show the proportional benefit of the executive activities to the Center.
 - The Board should be in a position to understand whether this arrangement will generate a sudden increase in compensation that would violate the principles of deductibility under Section 162. In this regard, it will be important for the Board to understand the affected Executives' current compensation arrangements, including whether their compensation is for full-time or part-time services and the previous history of raises.
- Practical Considerations Concerning Incentive Compensation
 - Incentive compensation is subject to heightened scrutiny.
 - Total compensation that is calculated with reference to gross revenues and without reference to the Center's exempt purposes and specific performance benchmarks (i.e. more efficiency, greater response to objectively defined community need) and comparability data may be problematic.

⁴⁵ See, for example, the Guidestar website, which shows comparability data for executive compensation in comparable areas.

BACKGROUND INFORMATION ON
SECTION 4958 OF THE INTERNAL REVENUE CODE⁴⁶

*A HISTORICAL LOOK AT REASONABLE COMPENSATION AND CONTINGENT
COMPENSATION (1950s / 1960s)*

In *Enterprise Railway Equipment Company v. United States*,⁴⁷ the United States Court of Claims considered whether there was a genuine issue of material fact as to the payment of excessive salaries to officers of a corporation—specifically, whether salaries deemed reasonable by the IRS as deductions from gross income under the predecessor to Section 162(a)⁴⁸ of the Internal Revenue Code would be equally reasonable under the predecessor to Section 501(c) of the Internal Revenue Code such that no part of the earnings of the corporation may be said to have inured to the benefit of an individual. The court ruled that "a salary . . . which is not excessive or unreasonable as an expense deduction from gross income under [the predecessor to Section 162(a)] of the Code, would not be excessive or unreasonable for the same corporation if it were claiming exemption from taxation as a charitable corporation under the provisions of [the predecessor to Section 501(c)] of the Code."⁴⁹

In Rev. Rul. 69-383,⁵⁰ the IRS considered whether an exempt hospital jeopardized its tax-exempt status by entering into a contract with a radiologist whereby the radiologist would be paid a fixed percentage of the radiology department's adjusted gross billings. The IRS concluded that the arrangement did not constitute private inurement because:

⁴⁶ This memorandum offers historical background which may be of use to the teacher who uses the materials. The memorandum draws from materials prepared by members of the staff of the law firm of Buchanan Ingersoll PC (available on the firm's website at www.bipc.com).

⁴⁷ 161 F.Supp. 590 (Ct. Cl. 1958).

⁴⁸ Section 162(a) provides in part:

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered

I.R.C. § 162(a)(1).

⁴⁹ *Enterprise Railway*, 161 F.Supp at 596.

⁵⁰ 1969-2 C.B. 113. (A copy of the Revenue Ruling is attached hereto.)

- **The radiologist did not control the organization;**
- **The agreement between the hospital and the radiologist was negotiated at arm's length; and**
- **The amount the radiologist received was reasonable in terms of the responsibilities and activities that he assumed under the contract.**

LEGISLATIVE HISTORY OF I.R.C. § 4958 (1980s)

The House Report underlying Section 4958 referenced three IRS General Counsel Memoranda which found certain revenue-sharing arrangements not to constitute inurement.⁵¹

GCM 38283⁵² considered whether the adoption and operation of a profit-sharing plan by a Section 501(c)(3) organization violated the requirements of exempt status—that the organization be organized and operated exclusively for charitable purposes, and that no part of its net earnings inures to the benefit of any private individual. It was acknowledged that the position in earlier GCMs was that a profit-sharing plan was "inherently incompatible with the accomplishment of charitable purposes" and that efforts toward maximization of profits could be at the expense of the employer's exempt function. That view, however, was admittedly shortsighted because it did not recognize the potential *benefit* of profit-sharing plans to an exempt employer. "As a matter of management theory, it is well-established that incentive compensation plans, including the various forms of profit-sharing, are of material aid in increasing employee productivity, with consequent benefit to the employer." Thus, the GCM concluded that an exempt organization would not violate the requirements of exemption by adopting and operating an incentive compensation plan that was based partly on profits of the organization, as long as the compensation was reasonable and the plan was properly supervised and controlled.

⁵¹ The report notes:

Under present law, certain revenue sharing arrangements have been determined not to constitute private inurement (see e.g., GCM 38283; GCM 38905 and GCM 39764) and, under the proposal, it would continue to be the case that not all revenue sharing arrangements would be improper private inurement. However, the Committee intends no inference that Treasury or the Internal Revenue Service are bound by any particular prior unpublished rulings in this area.

H.R. Rep. No. 104-506, at 56, n.4 (1996).

⁵² Gen. Couns. Mem. 38283 (Feb. 15, 1980). (A copy of the GCM is attached hereto.) A GCM cannot be relied upon as precedent. See, e.g., *Vons Companies, Inc. v. U.S.*, 51 Fed. Cl. 1 (Fed. Cl., Nov. 6, 2001).

General Counsel Memoranda do not establish precedent, but may be used as a research tool. When reasonable, they may be afforded the same deference as any informal interpretation by the IRS of a statute or regulation, but, in that regard, hold no special significance.

Id.

GCM 38905⁵³ considered whether an exempt title-holding corporation controlled by Section 501(c)(3) organizations could enter into a contingent compensation agreement with an investment manager without violating the private inurement prohibition. The investment manager would be charged with providing property management services with respect to the properties held by the title-holding corporation. The agreement provided for investment management fees to be calculated as either a percentage of the aggregate purchase price of the stock of the title-holding corporation or a percentage of the net asset value of the title-holding corporation. The GCM considered the proposed arrangement based on the following five factors:

- **Whether the arrangement was at arm's length;**
- **Whether the contingent payments served a real and discernible business purpose of the exempt organization;**
- **Whether the amount of compensation was dependent upon the accomplishment of the objectives of the contract rather than principally upon incoming revenue of the exempt organization;**
- **Whether the arrangement could result in abuse or receipt of unwarranted benefits by the service provider; and**
- **Whether there was a ceiling or reasonable maximum so as to preclude the possibility of a windfall benefit to the service provider based upon factors bearing no direct relationship to the level of service provided.**

First, the GCM recognized that the agreement was arm's length and that the investment manager did not participate in the management or control of any of the exempt organizations. Second, it was believed that the arrangement served a real and discernible business purpose because such an arrangement was customary in the industry, necessary in order to secure expert investment advice, and substantially less complicated and less expensive than other fee structures. Third, the amount of compensation was somewhat correlated with the level of services performed by the investment manager. Fourth, there was no indication that the compensation arrangement would result in abuse or the receipt of unwarranted benefits by the investment manager due to, among other things, safeguards in the organizational documents which included a provision allowing for termination of the investment management agreement with or without cause by the board of directors or shareholders. Fifth, even though the compensation under the agreement was capped for a number of years, and there was a possibility of a windfall benefit to the

⁵³ Gen. Couns. Mem. 38905 (June 11, 1982).

investment manager in the case where market conditions favorably affected the value of the investments, the GCM reasoned (i) that the effect of any windfall would be offset, to the extent that the amount of services required of the investment manager was positively correlated with the value of assets managed, (ii) that the investment manager was without control of the market conditions, and (iii) that the investment manager also bore the risk of loss due to unfavorable market conditions. Therefore, the proposed compensation agreement did not result in prohibited inurement.

GCM 39674⁵⁴ considered whether the establishment of profit-sharing incentive compensation plans for hospital employees resulted in private inurement or private benefit inconsistent with exemption under Section 501(c)(3). The factors considered in evaluating each plan were:

- Whether the plan was consistent with exempt status;
- Whether the plan was the result of arm's length bargaining; and
- Whether the compensation under the plan, as well as all other compensation, was reasonable.

First, the GCM noted that the profit-sharing plans were not inconsistent with exempt status because they were established to advance the exempt purpose of the hospital by improving the quality and efficiency of patient care and they appeared reasonably designed to accomplish exempt purposes. Second, the plans were the result of arm's length bargaining, and covered management and nonmanagement employees in one case (wherein employee-directors were prohibited from voting on any matter affecting the plan), and nonmanagement employees in the other. Third, the GCM made no determination on whether the compensation arrangements were reasonable. Therefore, the GCM concluded that, subject to the determination of whether the compensation paid under the plans was reasonable, the mere establishment of profit-sharing plans did not result in private inurement or private benefit which would cause the hospitals to lose their tax-exempt status.

THE IRS ADDRESSES EXEMPT ORGANIZATION COMPENSATION ISSUES (1987)

In 1987, the IRS addressed the issue of compensation in the Exempt Organizations Continuing Professional Education Technical Instruction Program for 1988.⁵⁵ The analysis was part of a healthcare update which focused on executive compensation. Among other things, the topics of reasonable compensation and contingent compensation arrangements were discussed.

⁵⁴ Gen. Couns. Mem. 39674 (June 17, 1987).

⁵⁵ Exempt Organizations Continuing Professional Education Technical Instruction Program for 1988 (Section C: Health Care Update). (A copy of *Section C: Health Care Update* is attached hereto.)

With regard to reasonable compensation, the analysis acknowledged that the determination of whether a salary is "reasonable" is a facts and circumstances test, and that, over the years, specific factors have been discussed in various revenue rulings, court cases, and general counsel memoranda. Acknowledging that those factors are not all-inclusive, and that there may be other circumstances that play a part in determining whether a salary is "reasonable," the analysis proceeded discuss previous authority and summarize the authority into four primary factors:

- **Whether the agreed upon compensation has been the result of arm's-length negotiation between the parties;**
- **The extent of control by the party receiving the compensation over the exempt organization or the compensation process;**
- **Whether the amount of compensation received is reasonable in terms of the responsibilities assumed and activities performed, and whether the amount of compensation is reasonable when compared to the amounts received by similar individuals having similar responsibilities at similar establishments; and**
- **Whether the salary would qualify as an expense deduction under Section 162(a).**

With regard to contingent compensation arrangements, the overriding consideration is that "the facts and circumstances should not reflect a significant incentive for the executive to promote his own interest at the expense of the charitable endeavors of his exempt employer."

*THE IRS ADDRESSES EXEMPT ORGANIZATION
COMPENSATION ISSUES AGAIN (1992)*

In 1992, the IRS addressed the issue of "reasonable compensation" in exempt organizations in the Exempt Organizations Continuing Professional Education Technical Instruction Program for 1993.⁵⁶ The article is useful in that it identifies many factors involved in deciding whether compensation is reasonable. While the factors were actually derived from analyses of reasonable compensation under I.R.C. § 162, the authors collected numerous exempt organization cases which discussed many of the factors in the exempt organization context. The factors, and a brief explanation of each, are set forth below:⁵⁷

⁵⁶ Jean Wright and Jay H. Rotz, Exempt Organizations Continuing Professional Education Technical Instruction Program for 1993.

⁵⁷ It is important to note that the IRS Exempt Organizations Continuing Professional Education Technical Instruction Program texts do not constitute binding authority; rather, the materials are prepared for

- ***Arm's length relationship*** - An employer and employee should negotiate a compensation arrangement at arm's length.
- ***Control by a family or founder*** - An abusive situation may occur when an exempt organization is dominated by one family. This abuse sometimes arises in cases of domination of a church by its founders, who are paid excessive salaries.
- ***Availability of comparable services from a third party*** - An employer should ascertain whether it can obtain comparable services at a lower rate from someone other than the employee in question.
- ***Nature of employee's duties*** - Employees who perform highly specialized and skilled work, are responsible for a large volume of work, or supervise other employees, may command a higher salary than others.
- ***Employee's background and experience*** - Employees who are particularly well-qualified for a position because of relevant prior experience, education, or proven expertise, may command a higher salary than others.
- ***Employee's salary history*** - If an employee receives a substantial salary increase, the reasonableness of the salary could be questioned. Such an increase may be proper, however, if the employee has historically been underpaid and the increase is bringing the salary up to a reasonable amount, or if new duties or responsibilities have been placed upon the employee.
- ***Employee's contribution to the organization's success*** - Employees who contribute to the success of an organization may properly receive higher compensation. In the context of an exempt organization, the analysis would focus on the employee's contribution to the organization's accomplishment of its exempt purposes.
- ***Time devoted to job*** - Obviously, employees who share their time with other organizations may command a lower salary than those who devote their full-time efforts to an organization.
- ***Salary scale of others in the same line of business*** - Generally, a reasonable salary paid to an employee is that which "would ordinarily be paid for like services by like enterprises under like circumstances."⁵⁸
- ***Size of the organization*** - Larger organizations may require employees to take greater and more difficult tasks, thus justifying a higher salary.
- ***Salary scale for employees generally*** - When an organization pays a disproportionately higher salary to certain employees, which is, for example, out of

educational use only. The materials are useful, however, as they present the latest IRS thinking on important topics affecting exempt organizations.

⁵⁸ Treas. Reg. § 1.162-7(b)(3).

line with the overall salary scale of the organization, a question as to the reasonableness of the salary could be raised.

- ***Amount of the organization's income devoted to compensation*** - If an organizations' entire income, or a significant portion thereof, goes to its employees in the form of salaries and other benefits, the reasonableness of such salaries could be brought into question.
- ***Criteria for compensation*** - It may be a good idea for an organization to establish clear criteria for an employee's compensation--spelling out the employee's duties and responsibilities, and identifying some measure of success.
- ***Abrupt increases in compensation*** - Large salary increases paid by an organization over a short period of time may suggest that factors other than an increase in an employee's duties or hours worked may be at play.
- ***Salary fixed many years in advance*** - An employer should avoid establishing a salary for an employee that is fixed far in advance of the actual performance of services because the organization may lose the ability to adjust to changing market conditions.
- ***Substantiation of duties performed and salary paid*** - An employer should keep records setting forth the duties performed by its employees and the hours worked by those employees.

In addition to the above factors related to the reasonableness of compensation, the article also discusses contingent compensation arrangements. Contingent compensation arrangements are addressed in I.R.C. § 162 and the accompanying Treasury regulations:⁵⁹

The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. 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.

⁵⁹ Treas. Reg. § 1.162-7(b)(2).

One outcome which seems to be troubling to the IRS in the context of contingent compensation under I.R.C. § 162 is when a large contingent payment results from reasons unrelated to an employee's productivity, such as a large payment due to fortuitous economic conditions.⁶⁰ The article acknowledges that contingent compensation arrangements in the context of exempt organizations are not expressly bound to an I.R.C. § 162 analysis; however, in practice, the analyses are similar. For example, in Rev. Rul. 69-383 and GCM 39674 discussed above, the compensation was negotiated at arm's length and was reasonable.

An additional factor discussed in the article with regard to incentive compensation arrangements in exempt organizations is the presence of a cap or ceiling on total compensation. In *People of God Community v. Commissioner*,⁶¹ the Tax Court considered whether a minister's compensation, which was based upon a percentage of gross tithes and offerings received by his church, resulted in private inurement. The Tax Court acknowledged that contingent compensation arrangements by charitable organizations are not per se in violation of tax-exempt status, but indicated that, "By basing [the minister's] compensation upon a percentage of petitioner's gross receipts, *apparently subject to no upper limit*, a portion of petitioner's earnings is being passed on to [the minister]."⁶²

⁶⁰ See *Ken Miller Supply, Inc. v. Commissioner*, 37 T.C.M. 974 (1978) (wherein at least a portion of the employee's compensation, which was based on a percentage of corporate profits, was due to a boom in the oil supply industry and to inflation).

⁶¹ 75 T.C. 127 (U.S. Tax Ct., Oct. 14, 1980).

⁶² *People of God*, 75 T.C. at 132 (emphasis added).