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The Semantic Anomaly: Maintenance of Qualified Profit-Sharing Plans by Non-Profit Organizations—A Concept Whose Time Has Come

Over the course of the history of American business the area of employee compensation has undergone vast changes in a relatively short period of time. In the past it was sufficient to compensate employees commensurate with their contribution to the employer's business during their active years of employment. However, with the advent of progressive income tax rates and the advancement of the standard of living came differing needs in the area of compensation packages. One of the major objectives of the new compensation plans was to minimize joint after-tax costs. Employers accomplished this objective by providing collateral fringe benefits, such as medical, disability, and life insurance, which qualify for special tax treatment. However, there was still a need for incentives for employees meriting supplemental compensation, which dollar-for-dollar direct current compensation could not provide. Employers devised special deferred compensation plans to fill this need. These plans provided employees with incentives either to increase efficiency or to share in the profits for which they were directly responsible, while at the same time, the deferred compensation plan minimized tax costs.

The United States Congress encouraged the development of deferred compensation plans by allowing favored tax treatment not only for the earnings on trust investments used to fund these plans

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3 For a further explanation of deferred compensation plans, see Part I(A) infra.

4 For a definition of "incentive compensation plans," see Part I(A) infra.

5 For a definition of "profit sharing plans," see Part I(A) infra.

6 See notes 19-21 infra and accompanying text.

7 To meet the requirements of I.R.C. § 401, a plan must involve contributions to a trust. These contributions will then be invested to earn income over the plan's life. This income
but also for the employer and the employee. Through the use of such plans, employers were able to offer more attractive compensation packages and concurrently benefit from the increased productivity and profitability these plans produced.

The Internal Revenue Service ("IRS" or "Service"), however, has allowed only profit-making businesses to take advantage of these deferred compensation plans. Tax exempt organizations have been unable to make use of these plans for two reasons. First, non-profit organizations do not have "profits" in the traditional sense sufficient to qualify for tax exempt status under Internal Revenue Code (I.R.C. or "Code") section 401. Second, such a plan would violate the requirements of I.R.C. section 501(c)(3) which grants tax exempt status to qualifying organizations.

In a recently published General Counsel Memorandum ("G.C.M."), however, the IRS reversed its attitude toward these plans and allowed a section 501(c)(3) hospital to maintain an incentive compensation plan, qualified under section 401(a), without endangering its tax exempt status. Although confined to its facts, this G.C.M. may reflect a movement within the IRS toward recognizing the viability of these plans in a tax exempt context. If so, section 501(c)(3) organizations, such as hospitals and educational institutions, could begin to take advantage of the tax benefits available to their profit-making counterparts and allow these organizations to attract and compete for the more qualified employees in their respective areas.

Part I of this note discusses the mechanics of I.R.C. section 401 under which most companies may qualify a profit-sharing trust for tax exempt status. Part I also discusses the IRS' past objections to allowing a section 501(c)(3) organization to qualify for such plans under section 401 and analyzes the Service's new G.C.M., which may

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8 See notes 19-21 infra and accompanying text.
9 "Tax Exempt Organizations" as used in this note will be limited to organizations exempt from tax under I.R.C. § 501(c)(3) (West Supp. 1981).
10 See note 17 infra.
11 See Part II(A) infra.
12 General Counsel Memorandums are published pursuant to the Freedom of Information Act.
13 General Counsel Memorandums (G.C.M.) are legal opinions generated by the General Counsel of the IRS for the guidance of the Service's technical staff. The G.C.M.s are usually prepared in conjunction with Private Letter Ruling requests. Although a G.C.M. does not have the force of law and is not binding upon the Service, they are generally followed by the technical staff within the IRS.
signal a movement away from its earlier position. Part II examines the general requirements for tax exempt status under I.R.C. section 501(c)(3), discusses the IRS' past views toward the impact of a profit-sharing plan on that tax exempt status, and analyzes what the Service's new G.C.M. may mean in this area. Finally in Part III, this note concludes that the new IRS position is correct and that it should be extended to further benefit tax exempt organizations.

I. I.R.C. Section 401

A. General Mechanics

In the "for profit" sector of American business, the terms "normal" or "base" compensation are often used to describe a level of current remuneration paid to an employee concurrently with the employee's performance of services. Alternatively, the term "deferred compensation" describes a category of diverse arrangements possessing one distinguishing common feature--actual payment of remuneration is delayed for a period of time after the employee's performance of the services entitling him to such compensation.

A deferred compensation arrangement may take many forms including "incentive compensation plans" and "qualified profit-sharing plans." A profit-sharing plan is generally a plan in which employees may participate in the company profits. A "qualified" profit-sharing plan is a profit-sharing plan that meets the requirements of section 401(a). A plan fulfilling the requirements may receive spe-
cial tax treatment that benefits both employer and employee. First, an employer who makes contributions to the "qualified" plan may take a current deduction\(^{18}\) for the contributions when paid even though the employee does not receive his benefits until a future time.\(^{19}\) Second, the employee is not taxed on his share of plan funds until he receives the future distributions.\(^{20}\) This is attractive to employees since they receive the distributions in later years, when they are usually in lower marginal tax brackets and may qualify for additional tax benefits.\(^{21}\) Finally, the funds contributed by the employer to the plan earn income until distribution. During this period, if the plan is qualified under I.R.C. section 401, all income earned by the funds is tax exempt.\(^{22}\)

In an incentive compensation plan, a company allows its employees to share in any increased cost savings which the employees produce. The objective is to provide an incentive for the employees to increase their efficiency and productivity. An incentive compensation plan may also be a deferred compensation plan. If the employees' share is paid out currently, nothing is deferred. The deferred element arises, however, if the funds are paid into a deferred plan or qualified profit-sharing trust.\(^{23}\)

Of course, non-tax managerial factors should be taken into ac-
count when a company considers a compensation package. Tax consider-
ations, however, usually heavily influence the company's choice, and the minimization of joint after tax costs is usually a pri-
mary objective.

Viewed from a tax perspective, then, different situations can ex-
ist with respect to a company's compensation package. An incentive compensation plan, for example, can cause diverse tax consequences depending on how it is structured. If under the program the company pays out the employee's share currently, then the employer gets a current deduction\textsuperscript{24} while the employee is taxed currently on the amount received.\textsuperscript{25} If under the program the company makes pay-
ments into a deferred compensation plan which fails to qualify under I.R.C. section 401, then the income earned on those funds is not tax exempt under I.R.C. section 501. Furthermore, the employer will generally only be allowed a deduction for contributions to the plan in the year the contribution is includable in the employee's gross in-
come.\textsuperscript{26} If, on the other hand, the plan meets the requirements of I.R.C. section 401, then the income earned on the funds will be tax exempt under I.R.C. section 501. Additionally, the employer will get a current deduction\textsuperscript{27} and the employee will not be taxed until the year he receives the distribution.\textsuperscript{28}

With minimization of joint after tax costs as the main objective, the last situation is clearly preferable. Moreover, qualifying a plan under section 401 may also be preferable since section 401(k), and the proposed regulations thereto, allow companies to take advantage of salary reduction features available only to qualified plans.\textsuperscript{29}

\textsuperscript{26} When employers make contributions to deferred compensation plans not qualifying under § 401, the timing of the inclusion into the employee's income as well as the employer's deduction are subject to more complex rules. Under § 404(a)(5), if a plan is not qualified under § 401(a), contributions by the employer are not deductible until the year in which the contribution is includable in the gross income of the employee. The year of inclusion by the employee is usually controlled by § 402(b), which provides that such contributions shall be included in the gross income of the employee in accordance with § 83, except that the value of the employee's interest in the trust is substituted for fair market value for purposes of applying such section. I.R.C. §§ 404(a)(5), 402(b) (West Supp. 1981).
\textsuperscript{27} See note 17 supra.
\textsuperscript{28} See note 20 supra.
\textsuperscript{29} I.R.C. § 401(k) allows employers to qualify cash or deferred arrangements under § 402(a). Cash or deferred arrangements allow an employee to choose whether his employer should contribute a certain amount to a qualified profit-sharing plan on the employee's behalf or should instead remit that amount directly to him in cash. Generally, the right to choose between immediate receipt of payment and deferral would result in loss of tax deferral under the constructive receipt doctrine. However, under § 401(k) cash or deferred arrange-
The foregoing analysis has focused on the tax advantages accruing to employees and employers in the profit-making sector of American business. However, non-profit tax exempt organizations desiring to attract qualified employees and to provide those employees with incentives to increase efficiency may wish to accomplish these same objectives by also utilizing an incentive compensation or profit-sharing plan.  

Until recently, the IRS has been unsympathetic to non-profit organizations wishing to adopt such plans under I.R.C. section 401. The IRS’ principal argument was that a non-profit organization cannot have “profits” in the traditional sense and that the term “profit-sharing” as used in section 401 refers to distributable gains or “for profit” enterprises.  

In 1980, in response to a request for a private letter ruling by a non-profit hospital wishing to qualify an incentive compensation plan under I.R.C. section 401, the IRS reconsidered its previous position. In G.C.M. 38283, the Service made a distinction between “profit” in the ordinary commercial sense and “profit” in a broad general accounting sense. The Service determined that profit in an ordinary commercial sense meant the amount available for disbursements, this election does not destroy the tax deferral. See I.R.C. § 402(a)(8) (West Supp. 1981); see also 12 RIA FEDERAL TAX COORDINATOR 2d at 27,482A (1984). These plans are made even more attractive under the proposed regulations, which allow a cash or deferred arrangement to be in the form of a salary reduction agreement between the employee and employer. Under such an agreement, a plan contribution will be made by the employer only if the employee elects to reduce his compensation or to forgo an increase in compensation. Treas. Reg. § 1.401(k)-1(a)(1) (proposed 1981). The use of such plans is attractive also because they permit the company to set up a profit-sharing plan where all contributions are made with untaxed employee dollars. See 12 RIA FEDERAL TAX COORDINATOR 2d, supra, at H-9002.  

The tax-exempt organization does not benefit, as does a profit-making enterprise, from the current deduction feature of a qualified plan. However, under a qualified plan, the income earned on funds is exempt from tax and the employees can take advantage of the deferral privilege. Thus, the tax-exempt organization can use these plans, as do profit enterprises, to attract better employees to enable them to provide services on a comparable basis.  

In G.C.M. No. 35865 (1974), the Service addressed a request for a private letter ruling by an exempt educational institution and municipality attempting to qualify a profit-sharing plan under § 401. The Service, citing Rev. Rul. 66-174, 1966-1 C.B. 61, stated that the term “profit-sharing” as used in § 401 refers to distributable gains of for profit enterprises. Thus, since an exempt organization does not have “profits” as that term is used in § 401, it cannot maintain a qualified profit-sharing plan under that section.  

G.C.M. No. 38283 (1980). For information concerning the hospital and incentive plan under consideration in this G.C.M., see notes 58-61 infra and accompanying text.  

For a description of the incentive compensation involved, see notes 58-61 infra and accompanying text.
tionary distribution to those with a proprietary interest\(^{34}\) (i.e. shareholders). Profit in a general accounting sense, however, meant an excess of revenues over expenditures.\(^{35}\) Therefore, the Service reasoned, a "profit" (in an accounting sense) could be produced by a non-profit organization, since a non-profit organization can have an excess of revenues over expenditures. The Service also pointed out that although the legislative history of the profit-sharing plan provisions of I.R.C. section 401 indicate that they were considered only in the context of business enterprises for profit, it was appropriate to apply general accounting principles and definitions developed in a commercial setting to non-profit organizations. Responding to this private letter ruling, then, the IRS withdrew from its previous position and acknowledged that a tax exempt charitable organization (hospital) can have "profits" as defined in I.R.C. section 401. Thus, a charitable organization could set up an incentive compensation plan under section 401 and gain the tax advantages such a plan provides.

Moreover, the Service, in G.C.M. 38283, recognized that while a non-profit organization may produce a "profit," it did not become a "for profit" enterprise as long as the excess is used to further the organization's exempt purpose.\(^{36}\) Even assuming that a non-profit organization can meet the requirements of "profits" in I.R.C. section 401, that alone is a pyrrhic victory for the exempt organization. The

\(^{34}\) The IRS, in G.C.M. No. 38283, stated that the hallmark of nonprofit organizations is that no part of its net earnings or other receipts is distributable to its members, directors, or officers except as reasonable compensation for services rendered. Thus, if the term "profits" is defined as those amounts available for distribution, as in Rev. Rul. 66-174, this hallmark would crumble, and a non-profit organization could never qualify a plan under I.R.C. § 401.

\(^{35}\) See E. Kohler, A Dictionary for Accountants 345 (4th ed. 1970) where "profits" is defined as "[a] general term for the excess of revenue, proceeds or selling price over related costs"; see also In re Lett's Estate, 200 Cal. App. 2d 708, 19 Cal. Rptr. 502 (2d Dist. 1961); Citizens Nat'l Bank v. Col, 225 N.C. 96, 33 S.E.2d 613 (1943); Clifford v. Gabbard, 305 S.W.2d 668 (Tex. Civ. App. 1957) (state law defining profits as gain from transactions or operations or the excess of revenue over expenditure); H. Oleck, Non-Profit Corporations, Organizations, and Associations 16 (3d ed. 1974).

\(^{36}\) Financial gain accruing to an organization does not make it a for profit organization as long as those gains are devoted to its exempt purpose. See Debs Memorial Radio Fund, Inc. v. Commissioner, 148 F.2d 948 (2d Cir. 1945); Griesman v. Newcomb Hosp., 76 N.J. Super. 149, 183 A.2d 878 (1962); Burton Potter Post No. 185 v. Epstein, 219 N.Y.S.2d 224 (Sup. Ct. 1961). Thus, the test of whether or not an organization is non-profit is not whether the organization had an excess of revenues over expenses, but rather whether or not that excess or other pecuniary gain is distributable to its owners or those with a private interest. See also Trinidad v. Saguade Orden de Predicadores, 263 U.S. 578 (1924) (where this proposition was recognized 60 years ago); People ex. rel. County Collector v. Hipデート医. Found., 46 Ill. 2d 450, 264 N.E.2d (1970); Associated Hospital Serv., Inc. v. Milwaukee, 13 Wis. 2d 447, 109 N.W.2d 271 (1961). See generally H. Oleck, note 35 supra.
question remains whether the maintenance of such a plan will violate the requirements of I.R.C. section 501(c)(3), endangering the organization's tax exempt status.

II. I.R.C. Section 501(c)(3)

A. General Framework

I.R.C. section 501(a) provides that any organization described in section 501(c) or (d), or section 401(a), will be exempt from taxation. To meet the requirements of section 501(c)(3), an organization must be organized and operated exclusively for its exempt purpose and no part of its net earnings may inure to the benefit of any private individual. To be “organized” exclusively for charitable or exempt purposes means “created to perform” or “established to promote” charitable purposes, and not merely “incorporated” with powers limited solely to charitable purposes.

A section 501(c)(3) organization must also in fact “operate” exclusively for charitable or exempt purposes (operational test). The Code does not define “exclusively.” Although its meaning would appear to be self-evident, the term has been interpreted to mean “primarily” or “substantially” in furtherance of an exempt purpose. Thus, insubstantial non-exempt activities do not destroy the exemption.

Closely associated with the operational test is the Code's prohibition against inurement of the organization's net earnings to any private individual. The proscription against inurement can be vio-

38 I.R.C. § 501(c)(3) explicitly states these tests as follows: “Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual. . . .”
40 See Squire v. Students Book Corp., 191 F.2d 1018 (9th Cir. 1951); Estate of Philip K. Thayer, 24 T.C. 384 (1955); Alan Levin Found., 24 T.C. 15 (1955); Marian Found., T.C.M. (PH) ¶ 60,018; Rev. Rul. 77-366, 1977-2 C.B. 192. The Regulations provide that an organization is not operated exclusively for an exempt purpose if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Treas. Reg. § 1.501(c)(3)-1(e)(1)(1959).
41 See Better Business Bureau v. United States, 326 U.S. 279 (1945); Northern Cal. Cent. Serv. v. United States, 591 F.2d 620 (Ct. Cl. 1979); see also Note, Has the Supreme Court Laid Fertile Ground for Invalidating the Regulatory Interpretation of Internal Revenue Code Section 501(c)(3) ?, 58 NOTRE DAME L. REV. 564, 575 (1983).
42 The Regulations specifically provide that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of a private shareholder or individual. Treas. Reg. § 1.501(c)(3)-1(e)(2)(1959). The words "pri-
lated in a number of ways. Charitable organizations, however, may pay employees "reasonable compensation" for their services, without violating either the exclusive operation requirement or the prohibition against private inurement.

B. The IRS' Position

1. Incentive Compensation Plans

As previously discussed, incentive compensation plans are generally used by a company to increase efficiency, improve quality and

private shareholder or individual" have been defined as "persons having a personal and private interest in the activities of the organization." Treas. Reg. § 1.501(a)-1(c)(1959). This prescription, however, does not apply to unrelated third parties. Goldsboro Art. League v. Commissioner, 75 T.C. 337 (1980).

If profits, whether direct or indirect, are distributed, then net earnings inure to a private interest. Horace Height Found. v. United States, 170 F. Supp. 634 (Ct. Cl. 1959); John Joseph Cranley, Jr., T.C.M. (PH) ¶ 61,004; Wells & Wade, Inc. v. United States, 280 F.2d 828 (Ct. Cl. 1960); Bubbling Well Church v. Commissioner, 670 F.2d 104 (9th Cir. 1981), aff'd 74 T.C. 531 (1980); Rev. Rul. 77-70, 1977-1 C.B. 150. The payment of personal or living expenses of the founder will also constitute prohibited inurement. See William H. Kenner, T.C.M. (PH) ¶ 61,037, aff'd, 318 F. 2d 632 (7th Cir. 1963); see also John Marshall Law School v. United States, 1981-2 U.S. Tax. Cas. ¶ 9514 (Ct. Cl. 1981), aff'd per curiam, 1981-2 U.S. Tax Cas. ¶ 9745 (Ct. Cl. 1981), where shareholder received interest free loans, a home, furniture, educational expenses for his children, personal travel expenses, insurance and health benefits, automobiles, health spa memberships, and even season tickets to sporting events. Mabee Petroleum Corp. v. United States, 203 F.2d 872 (5th Cir. 1953), where "excessive" salaries paid to officers constituted prohibited inurement; Loraine Ave. Clinic, 31 T.C. 141 (1958), where the court held that a compensation plan for services which predominantly compensated its physicians on the basis of the ratio of his fees and activities to the whole constituted in reality a joint venture between the physicians and the clinic and therefore was prohibited. But see Rev. Rul. 69-383, 1969-2 C.B. 113, where the IRS distinguished a situation where, after arms length negotiation the hospital and a hospital based radiologist entered into an agreement to compensate him on a fixed percentage of departmental income from that involved in Lorain Ave. Clinic, 31 T.C. 141 (1958).

See Birmingham Business College, Inc. v. Commissioner, 276 F.2d 476 (5th Cir. 1960) (payment of reasonable salaries or even anticipated expectation of such payment does not constitute earnings inuring to the benefit of those who created the organization); Enterprise Railway Equip. Co. v. United States, 161 F. Supp. 590 (Ct. Cl. 1958) (where salary paid to officer in the form of pension fund contributions if not excessive or unreasonable as an expense deduction from gross income would not constitute inurement); Mabee Petroleum Corp. v. United States, 203 F.2d 872 (5th Cir. 1953) (where although salaries were excessive and therefore constituted inurement, the court stated that payment of reasonable salaries does not constitute inurement). An exempt organization can also incur ordinary and necessary expenditures in its regular activities without losing its exempt status, as in St. German Foundation, 26 T.C. 648 (1956), where the payment of reasonable personal living expenses of its staff who did not receive regular salaries did not constitute inurement. Accord Golden Rule Church Ass'n, 41 T.C. 719 (1964), and A.A. Allen Revivals, Inc., T.C.M. (PH) ¶ 63,281. What constitutes "reasonable" compensation or salary is a question of fact to be resolved in light of all the facts and circumstances. Bubbling Well Church v. Commissioner, 74 T.C. 531 (1980), aff'd, 670 F.2d 104, (9th Cir. 1981).
productivity, and reduce costs, by making incentive payments to employees based upon the cost savings the employees produce. Although an incentive compensation plan can take on characteristics of a profit-sharing plan, they are usually fundamentally different from profit-sharing plans used by "for profit" businesses (which customarily provide deferred compensation for employees based upon a share of the company's profits). For example, since the realization of profits is not a prerequisite, an incentive compensation plan based on employee generated cost savings can provide benefits even if the organization has incurred a net loss from one year to the next. However, for over ten years, the IRS has failed to distinguish between incentive compensation plans based upon sharing cost savings and profit-sharing plans based upon a sharing of earnings or profit. As a result, the Service has refused to issue rulings that incentive compensation plans would not violate the proscription against private inurement.

Then in 1974 and again in 1976, the IRS responded to requests for private letter rulings from two section 501(c)(3) hospitals. The requests generated two G.C.M.s approving incentive compensation plans. The hospital incentive plan reviewed in G.C.M. 35638 (1974) rewarded participating employees for their contribution to increased productivity on the basis of qualitative measurements of both the quality and quantity of services performed. Benefits were paid out on a quarterly basis. Most components of the formulas used to compute the incentive compensation were controllable expenses, generally based on savings of supplies, working hours, or a combination of the two.

In distinguishing the incentive compensation plan at issue from

45 For example, if the contributions are paid into a trust which the company wishes to qualify under § 401(a), it must be in profit-sharing form, or if the plan's formulas for calculating the employee's share are dependent upon net income in whole or in part, the plan looks more like a profit-sharing plan as opposed to a traditional incentive compensation plan based on efficiency improvement or cost savings.

46 For a discussion of incentive compensation plans in a health care context, see R. Bromberg, Tax Planning for Hospitals and Health-Care Organizations ¶ 7.8 (1977).

47 Usually these cost savings will be based upon expenses within the employee's control such as man hours, wages, or supplies, and not depreciation, rent, and the like.

48 For example, if the organization incurred a net loss in year one of $100 and a net loss in year two of $20, the $80 decrease in the net loss may be the result of increased efficiency or cost savings generated by the employees, allowing them to share in such increase even though the organization has no profits.


50 Therefore, no deferral element existed with the plan. See note 52 infra.
a prohibited profit-sharing plan, the IRS issued a favorable ruling based upon several factors. First, the plan's formulas contained maximums to ensure that compensation was not unreasonable. Second, management personnel such as the hospital administrator did not participate in the plan. Third, the benefits were paid quarterly so that no amounts were deferred through a profit-sharing trust. Fourth, the employee's benefits were not dependent upon a realization of net profits. Moreover, the plan provided that any deterioration in the quality of services would trigger termination of all benefits.

In G.C.M. 36918, the IRS was asked to rule on a plan virtually the same as the one involved in G.C.M. 35638. The plan payments were based on the saving of working hours, supplies, or a combination of the two. Again impressed by the fact that the plan was not dependent upon a realization of net earnings and that the impermissible features of a true profit-sharing plan were absent, the IRS issued a favorable ruling.

These private letter rulings may represent a retreat from the IRS' prior position on incentive compensation plans of non-profit organizations. However, the IRS distinguished these compensation plans from true profit-sharing plans, thereby giving no intimation that they would issue favorable rulings for true profit-sharing plans.

2. Profit-Sharing Plans

I.R.C. section 501(c)(3) explicitly prohibits inurement of net earnings to any private individual. In 1956, in Revenue Ruling 56-
185, the IRS labeled division of profits as one of the more blatant forms of inurement. Therefore, when faced with requests for private letter rulings with respect to true profit-sharing plans by tax exempt organizations, the Service has maintained a strict position disallowing these plans. For example, in 1963 a section 501(c)(3) educational institution requested a private letter ruling for a profit-sharing plan. This plan called for the segregation and allocation to a trust, for the exclusive benefit of the participating employees, of fifteen percent of the organization's net income. The IRS disallowed this profit-sharing plan. The IRS reasoned that the plan would conflict with the accomplishment of the educational institution's exempt purpose, violating both the proscription against inurement and the exclusive operation test.

In 1974, the same type plan was again examined, along with a similar plan by a municipality which called for the city to contribute a fixed percentage of its net revenues to an employee retirement plan. The IRS again expressed its disapproval of these plans and disallowed both. Thus, although certain non-deferred incentive compensation plans may be compatible with a section 501(c)(3) organization's exempt purpose, after these rulings any attempt to qualify a true profit-sharing plan seemed unlikely to succeed.

In 1961, Memorial Hospital Medical Center of Long Beach, California, a section 501(c)(3) organization, inaugurated the Merit Plan (Memorial Employees Retirement Incentive Trust) as an incentive compensation plan for its employees. Under this program, the hospital was required to make annual contributions to a trust determined by applying an efficiency improvement percentage to the

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54 Rev. Rul. 56-185, 1956-1 C.B. 202. This Ruling set forth four general requirements a nonprofit hospital must meet to qualify for exempt status; the fourth criterion is: "[An exempt hospital's] net earnings must not inure directly or indirectly to the benefit of any private shareholder or individual. This includes the use by or benefit to its members of its earnings by way of a distribution of profits, the payment of excessive rents or excessive salaries. . . ." (emphasis added). Id.

55 This contribution was further limited in that it could not exceed five percent of the basic compensation paid for that year to the employees. G.C.M. No. 32518 (1963).


57 See note 49 supra and accompanying text.

58 The hospital was recognized as an exempt organization under I.R.C. § 101(b) (1939 predecessor to § 501(c)(3)). See G.C.M. No. 38283 (1980).

59 By determination letter issued by the District Director, the trust was held to qualify under § 401(a). See G.C.M. No. 38283 (1980).

60 In calculating the efficiency improvement percentage, the hospital uses a base period consisting of a three year average of the hospital's performance; the efficiency percentage is then calculated for the three year period by dividing controllable expenses by operating revenues. Factors over which the employees have no control, such as depreciation, debt, debt
hospital payroll.\textsuperscript{61} The Merit Plan, however, unlike the productivity incentive plans in G.C.M. 35638 and 36918,\textsuperscript{62} involved contributions into a trust rather than payment of benefits on a quarterly basis. In addition, since the IRS categorized this plan as a profit-sharing plan, they first had to address the section 401 issue.\textsuperscript{63} Once the IRS determined that a non-profit organization, such as the one involved, could have "profits" of a type sufficient to qualify under section 401, it had to decide whether maintenance of this profit-sharing plan would violate the prohibited inurement or exclusive operation test of section 501(c)(3).

The IRS, in a complete shift in perspective, held that the maintenance of a profit-sharing plan under section 401 may be compatible with the mandates of section 501(c)(3), provided certain safeguards exist. In discussing whether the plan violated the prohibition against private inurement, the IRS reasoned that, in the context of "for profit" organizations, amounts contributed to qualified profit-sharing plans are deductible under section 404(a), as long as the amounts constitute "reasonable compensation."\textsuperscript{64} Moreover, the Service reiterated that tax exempt organizations may also pay reasonable compensation for services received.\textsuperscript{65} Therefore, since the I.R.C. requires compensation, including compensation received through profit-sharing plans, to be "reasonable," a non-profit organization should be allowed to characterize contributions to such profit-sharing plans as ordinary and necessary deductions, so that net income does not inure to the benefit of any private individual.

Normally, satisfying the prohibited inurement requirement will

\textsuperscript{61} The plan is subject, however, to the following qualifications: The plan is open to any employee less than 65 years of age who has completed six months of full time employment who must apply and authorize a payroll deduction of not less than 10\% of his salary or wage as an employee contribution to the trust. The efficiency improvement percentage is limited to a 5\% maximum. The hospital's contribution to the trust may not be less than 1\% of the payroll, but may also not exceed the lesser of 50\% of the hospital's net operating gain or 15\% of participating employee contributions. See G.C.M. No. 38283 (1980).

\textsuperscript{62} See note 49 supra and accompanying text.

\textsuperscript{63} See Part 1(b) supra.

\textsuperscript{64} See LaMastro v. Commissioner, 72 T.C. 35 (1979); Branch v. Commissioner, 66 T.C. 324 (1976). Although both involved pension and not profit-sharing plan contributions, § 401(a) is applied similarly in both situations.

\textsuperscript{65} See note 44 supra.
not automatically satisfy the exclusive operation test. In this situation, however, the Service decided that satisfaction of the former is necessarily dispositive of the latter. The Service so decided because, if it is determined that there is no inurement due to the amount constituting reasonable compensation for services rendered, then the plan is serving the organization’s exempt purpose rather than a private interest.

Significantly, the IRS acknowledged, in G.C.M. 38283, the efficacy of incentive compensation and profit-sharing plans, in both “for profit” and non-profit organizations, as a means of increasing employee productivity. The IRS stated that, in the past, they felt that profit-sharing plans were inherently incompatible with the accomplishment of a charitable purpose because of the potential conflict between the personal interest of the employees, in the form of greater profit making efforts, and the organization’s exempt purpose. However, the IRS now believes that in the past they placed too strong an emphasis on the benefit that the employee derives. The IRS determined that more consideration should be given to the significant benefit accruing to the employer’s exempt function through incentive compensation plans. As long as the benefits to the employees con-

66 For example, an exempt organization could be involved in activities which do not further an exempt purpose but require no expenditures of resources, thus violating the exclusive operation test but not the proscription against inurement.

67 For example, the major benefit accruing to the non-profit organization, in a health care or hospital/medical context, is the dampening effect on costs and daily rates. Although relatively few health care institutions or hospitals utilize such plans, due to the uncertainty of such plans on their tax exempt status, those that have utilized them have had enormous success. Referring to the plan involved in G.C.M. No. 38283, in a 1975 article on health care incentive plans, the potential impact of employee incentive compensation plans on inflation in hospital costs was illustrated by the following quote: “[T]he expenses in U.S. hospitals for 1970 could have been reduced by $3.9 billion if the average per cent increase in expense per patient day for the nation’s voluntary hospitals had been as low as that of Memorial Hospital of Long Beach.” See R. Bromberg, The Effect of Tax Policy on the Delivery and Cost of Health Care, 53 TAXES 452, 473 (1975). The following examples of the savings generated by the employees of Memorial Hospital of Long Beach and Baptist Hospital of Pensacola, Florida, (using a plan similar to Memorial Hospital’s) illustrate the benefit which can accrue to the non-profit organization’s exempt function with the public as ultimate beneficiary:

(1) Employees of Memorial Hospital rebottled antiseptics in three and five ounce containers, eliminating waste in the housekeeping department and saving $2,579 a year.

(2) By finding a more efficient method of storing, handling, and washing glasses used for juice and water, the nursing and food service departments saved $2,000 in labor costs while improving sanitation and inventory control.

(3) By modifying equipment used to vacuum water from floors, employees saved two hours per day netting to $1,386 per year.

(4) The exchange of special mattresses took eight janitor hours per week until an employee suggested storing two hard and two foam mattresses in the linen closets on each floor as opposed to constantly moving them from the ground floor storeroom. $1,485 a year in
stitute reasonable compensation, such benefits are merely incidental to the organization’s exempt purpose. Therefore, the Service stated that its efforts should now be aimed at devising rules to ensure the realization of the benefit to the exempt function.

Regarding the plan under consideration in G.C.M. 38283, the Service’s main concern was that the plan be properly conceived and administered.\(^6\) The Service also stated that, at the present time, the limitation imposed upon profit-sharing plans by sections 401-418 of the I.R.C., along with those imposed by the Employee Retirement Income Security Act of 1974 (ERISA) as amended, should provide assurance that the plan is properly administered. The Service left open the possibility of formulating independent standards if problems arise under the system.

It is unclear how G.C.M. 38283 will affect other exempt organizations. Although G.C.M. 38283 has no precedential value, it does represent the first substantial authority for the proposition that an exempt organization may have a profit-sharing plan (or at least an incentive compensation plan) qualifying under section 401. Moreover, the plan involved in G.C.M. 38283 included the hospital administrator as an eligible participant. Thus, it appears that it may now be possible to allow senior management to participate in these plans, thus giving non-profit organizations the ability to compete more effectively for highly qualified management personnel.

The limitations of G.C.M. 38283, however, must not be ignored. The plan involved was an incentive compensation plan and not a traditional profit-sharing plan. Thus, today no authority exists for the proposition that a non-profit organization may institute a true profit-sharing plan without endangering its exempt status.

III. Conclusion

If the IRS follows its own reasoning, it should only be a matter of time before it approves a true profit-sharing plan for a non-profit organization. The same justifications for allowing the incentive compensation plan in G.C.M. 38283 apply with equal force to profit-sharing plans. As long as the compensation paid to employees under either an incentive compensation or a true profit-sharing plan is “reasonable,” then no earnings inure to the benefit of a private indi-

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\(^6\) G.C.M. No. 38283 (1980).
individual. Therefore, it is not necessary to distinguish between incentive compensation and true profit-sharing plans. Moreover, with the attractiveness of the salary reduction features of cash or deferred arrangements under Section 401(k) and the proposed regulations, the time has come for a more liberal federal tax policy in this area. Such a policy could pave the way for enormous improvements in competition between non-profit and for profit organizations. In fact, the time is ripe for the Treasury Department to adopt regulations which give more guidance to exempt organizations wishing to adopt qualified profit-sharing plans.

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