Nonprofit Alert®

Gammon & Grange PC

SUMMER 2008

Alerting nonprofit leaders to key legal developments and responsive risk management steps

IRS May Be Toughening Standards in Evaluating New and Existing Charities

Recent investigations by the Senate Finance Committee into how charities are raising and using their funds may be prompting the IRS to act more aggressively in evaluating applicants for tax-exempt recognition.

In what may be a sign that it is raising the bar for organizations to be recognized as tax-exempt, the IRS recently denied tax exemption to an organization in part because the group did not spend enough of its money on charitable programs. The IRS said the organization did not carry on a charitable program "commensurate in scope" with its financial resources. This ruling is the first public confirmation that the IRS is taking the approach that Steven T. Miller, Commissioner of the IRS' tax-exempt and government-entities division, announced last month when he stated that the IRS would embrace the "commensurate test" to help determine whether charities were spending money efficiently and effectively.

In its adverse determination, the IRS observed that the records the applicant organization filed with a state government showed that money the organization counted as contributions was "primarily from the sale of annuity plans." These state records also showed that expenditures on the organization's charitable program during the year accounted for less than half of one percent of its total revenue and about three percent of its total expenses.

The IRS concluded that the organization did not qualify as a charity because it was organized and operated for the primary purpose of running a business. "You do not carry on a charitable program that is commensurate in scope with your financial resources," the IRS asserted. At the same time, it appears that the IRS may be applying the commensurate test to monitor existing tax-exempt entities, and thus may be more closely scrutinizing charitable expenditures reported on Forms 990.

The IRS' use of the commensurate test is being lauded by Senator Chuck Grassley (R-IA) and Dean Zerbe, his former top lieutenant in the Senate Finance Committee, and may be an outcome of their well-publicized efforts to heighten the IRS' scrutiny of charitable organizations. Other commentators, however, have expressed doubts about the usefulness of the commensurate test given its vagueness.

Wedding Veils and Corporate Veils

When the wedding veil has been neglected, more pain may be in the offing if the corporate veil has also been neglected. This was highlighted in a recent New York case where a court stated that church assets could be considered marital assets subject to equitable distribution.

The wife of the pastor of Grace Christian Church, a nonprofit religious corporation, sued her husband for divorce and alleged that the church he founded operated as his own "personal piggy bank." Citing a number of alleged corporate abuses, the court determined that it was a question of fact whether the church was operated as the defendant's alter ego, potentially enabling the wife to pierce the corporate veil and value the church as a marital asset.

According to the wife's allegations, the defendant controlled all of the church's finances and made all financial decisions. The church's board of directors and administration had no access to financial records, and the defendant set his own income and referred to the church as "my church," dismissing anyone who challenged his control. The pastor claimed instead that he was merely an employee with no legal ownership interest in the church.

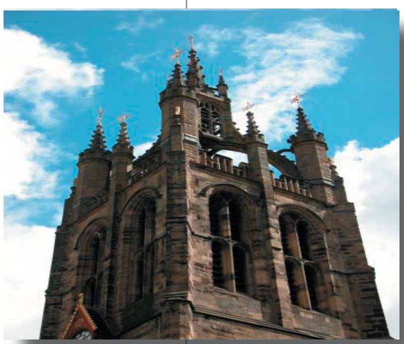
Despite acknowledging potential First Amendment issues, the court affirmed that religious corporations are governed by the same rules of law and equity as for-profit corporations with regard to exceptions to the normal liability shield between the assets of corporations and those of their directors, officers, and shareholders. As such, in this case the court ruled that a jury could find that the absence of corporate formalities breached the corporate veil, permitting corporate assets to be considered in the marital distribution.

Inside This Issue:

Gammon & Grange
8280 Greensboro Dr.
7th Floor
McLean, VA 22102
703-761-5000
npa@gg-law.com

Church? Not Says IRS

Three companion IRS Rulings clarify that the tax benefits of church status, while significant and alluring, will remain out of reach to religious missions that fail to intentionally organize and operate as churches. Churches, unlike most other religious or educational charities, do not need to apply for recognition of tax exempt status, are exempt from the annual Form 990 filing requirements, may confer housing allowance benefits on ordain ed pastors, and enjoy a high degree of protection from routine IRS audits. These and complementary state benefits (such as automatic exemptions from most state charitable solicitation requirements) can prompt some non-church religious charities to examine whether they might reengineer themselves to become a church.



While the tax code uses the term "church" widely, nowhere is it defined in the code. Thus when classification challenges arise, the IRS and the courts look to common law, common sense, and the IRS' 2 decade old 14-criteria test.

In these series of 3 Private Letter Rulings [PLR 200727021, PLR 200712047, and PLR 200712046], the IRS essentially extrapolates a 15th and most foundational criterion. All three entities were self-described missions agencies. Each agency recruited, trained, and sent missionary-ministers to various locations to preach the gospel of Jesus Christ, disciple believers in Biblical doctrine, and plant local churches. Each of these missions satisfied at least the first 5 of the 14 criteria: [1] distinct legal existence, [2] recognized creed and form of worship, [3] distinct ecclesiastical government, [4] formal code of doctrine and discipline, and [5] distinct religious history. The argument for church status became more problematic with the last 9 criteria, such as demonstrating that each had a distinct membership not associated with any other church or denomination, authority to ordain ministers, established places of worship, regular services, and Sunday schools for training children, etc.

The key tipping point in the IRS ruling against church-status, however, seemed to be each entity's self-description. Thus self-identification might logically be extracted from these 3 PLRs as the 15th and essential criterion.

The first missions agency failed to describe itself as a church anywhere in its governing documents, policies, or external communications. The IRS concluded the agency was not a church because it "describes itself as a 'non-denominational missions agency' and a 'faith mission' that 'serves in partnership with churches, related organizations and friends.' It does not identify itself to the public as a church."

The second two missions agencies had each amended their organizing documents to refer to themselves as "a church" as well as a "global evangelistic ministry." However the IRS concluded that this nominal change was a difference without distinction since neither agency "identif[ies] itself publicly as a church. Neither its website nor the literature it distributes to the public refers to it as a church. Rather it describes itself as a missions agency, a missionary society, an evangelistic agency, but not as a church. Its literature often distinguishes it, as a missions agency, from churches with which it partners."

Nor was the IRS persuaded that the conducting of semiweekly prayer meetings involving 15 to 35 staff was sufficient to beget a church metamorphism. The IRS concluded "these activities are incidental to the main activity of the central office, which is to exercise administrative, financial, and operation oversight… The conduct of devotional worship and prayer services does not convert an administrative office into a church… Furthermore, staff members all belong to other local churches, and do not consider the agency to be their church."

The lesson for religious entities exploring church-status is that the 14 criteria are alive and well, and have effectively grown to 15. And unless you reengineer all organizational, operational, and relational functions of your entity with these criteria in view, your aspirations for church status may prove to be Mission Impossible.

News Briefs

- Given the soaring cost of gas, the IRS has hiked the standard mileage rate for business use of vehicles to 58.5 cents per mile for the July 1 to December 31, 2008 period. This is an 8 cent increase over the rate for the first six months of the year. Normally the IRS adjusts the mileage rate only once a year, but given sharp increases in gas prices, it has made this special mid-year adjustment.

(continued on page 3)

Nonprofit *Alert*®
8280 Greensboro Drive, 7th Floor, McLean, VA 22102-3807
(703) 761-5000 Fax: (703) 761-5023 • E-mail: npa@gg-law.com

Editor-in-Chief . . . . George R. Grange II
Editor. . . . . Steve King
Publications Coordinator. . . .Jo-Anne Kehmna
Layout Design/Web Design . . . . . .Thomas Jubb

Survey of Volunteer Screening Practices

The National Center for Victims of Crime recently conducted a survey of the volunteer screening processes for nonprofit social service organizations. The NCVC's survey was funded with a grant from a background check agency. The results showed that 12% of the organizations surveyed do not screen volunteers at all. Most that do screen do so through interviews, references calls, and limited criminal records checks.

The survey showed the primary reasons for the lack of more thorough screenings are the expense of screening and the reluctance to potentially offend potential volunteers. Mary Lou Leary, executive director of National Center for Victims of Crime, encouraged organizations not to allow financial reasons to discourage volunteer screening searches. Rather, with the information available through the internet, local law enforcement, and the FBI, organizations can complete their own searches at a very low cost.

⇨ A lack of commitment to adequately screen volunteers, especially those working with children and youth, generally raises the risk of liability for an organization, as well as endangering the individuals served. Ultimately, the cost of screening volunteers is small in comparison to the potential damage to an organization's reputation.

UBIT-ter Allocate Correctly

The IRS plans to scrutinize more carefully charities reporting losses on their unrelated-business activities. A recent analysis by the IRS' Statistics of Income Division showed that more than half of tax-exempt organizations that file an unrelated-business activities return (Form 990-T) reported overall losses or zero taxable income. While recognizing that many reasons exist for reporting a loss on unrelated-business activities, such as initial start-up losses, the IRS is concerned that some charities might be misallocating their expenses.

Of particular interest to the IRS are the allocations of indirect expenses to unrelated activities in calculating the loss. Organizations need to ensure that they have clear methods and justifications for allocating expenses between tax-exempt work and unrelated business activities, since these methods of allocation can be expected to come under increasing scrutiny now that the Form 990-T is open to public disclosure.

Organizations also need to ensure that allocation of expenses between related organizations retain the elements of an arm's-length transaction. The IRS intends to carefully scrutinize arrangements where the determination of the amount of payments to a related organization appears to be motivated more by tax avoidance than by reflecting actual arm's-length value. Organizations that engage in cost-sharing or collaboration should be particularly careful to record the process and rationale behind the payment agreement with any related organizations.

⇨ For more information on unrelated business income, order Nonprofit *Alert*® memo *UBIT Primer for Nonprofits*

News Briefs (continued from page 2)

- According to a Giving USA report, charitable giving in the US increased a modest one percent in 2007. The increase was mainly due to foundation grants, with giving from individuals actually dropping slightly from 2006 levels (when adjusted for inflation). Given current economic uncertainties, many expect 2008 to be a tough year in the charitable giving arena.

- Recent IRS data indicates that there are currently approximately 1.13 million recognized 501(c)(3) organizations in the US, an increase of over 64,000 from 2006. During 2007, applications for 501(c)(3) recognition were filed by 85,771 organizations, with 68,278 being approved. Note that this data does not include the many thousands of churches that have not applied for IRS recognition of exemption given that churches are not required to obtain such recognition.

- The IRS recently announced the availability of matching grants to charities for the provision of income tax return preparation assistance to low and moderate income individuals. Applications for the Volunteer Income Tax Assistance (VITA) matching grant program are being accepted from July 1 through Sept. 2, 2008. Applications may be submitted at grants.gov.