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Nonprofit *Alert*®

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

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Senate Finance Committee Proposes Sweeping Changes in Nonprofit Regulation

The Senate Finance Committee has proposed ideas for legislation that would significantly increase regulation of tax exempt organizations. Committee Chair Charles Grassley (R-Iowa) has held two "Roundtable" discussions on these proposals and invited further feedback from the nonprofit community. The Committee's "Discussion Draft," released on June 21, 2004, includes dozens of proposed changes to existing law intended to tighten oversight of and curb abuses by nonprofits, including:

➥ Five year review of tax exempt status by the IRS. Every five years, a tax exempt organization would be required to reapply to the IRS for continuation of tax exempt status. Applicants would be required to pay a sliding scale processing fee. Failure to file the five-year return could result in loss of tax exempt status.

➥ Apply private foundation self-dealing rules to public charities. Generally, any kind of self-dealing transaction between a public charity and disqualified person would result in excise taxes to the disqualified persons and the charity's managers who approved the transaction. Intermediate Sanctions rules would be modified accordingly.

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➥ Donor advised fund ("DAF") restrictions.
The Discussion Draft proposed 11 restrictions on DAFs, including (1) a DAF could not make grants to individuals or non-operating private foundations; (2) contributions to a DAF other than cash or publicly traded securities would have to be sold within one year of contribution; (3) a DAF would have to secure a grantee's acknowledgment that the grant will not convey a private benefit to the advising donor; (4) private foundations could not make grants to DAFs; and (5) a DAF would have to pay out 5% of the DAF's assets each year. A tax would be imposed on DAFs that fail to meet this payout requirement.

➥ Revise exemption standards for credit counseling organizations. Nonprofits that provide such counseling would be required to charge no fee or a nominal fee for services provided to low-income individuals and families and would be subject to other new restrictions. Senator Grassley indicated that greater regulation of credit counseling groups will be his top priority in drafting new legislation.

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NonProfit Regulation Changes......[continued from page 1]

➥ Form 990 changes. Tax exempt organizations that are required to file an IRS Form 990 would be required to do electronically. Increased disclosures required on the Form 990 would include related organizations, insider transactions, performance goals, frequency of Board meetings, and tax opinions involving conflicts of interest transactions. A nonprofit's CEO would be required to sign a declaration under penalty of perjury that the nonprofit has implemented policies to ensure that the Form 990 complies with the Internal Revenue Code. The IRS could impose significantly higher fines (up to $2 million per year) for failure to timely file the Form 990 or to include required information.

➥ New Board duties and standards. The Board of a tax exempt organization would be required to consist of no fewer than three and no more than 15 members. No more than one Board member could be compensated by the organization, and a compensated member may not serve as the Board Chair or treasurer. Any individual who is not permitted to serve on the board of a publicly traded company could not serve on an exempt organization's board. The Board would have to establish program objectives performance measures, a conflicts of interest policy, and a legal compliance program. The IRS would have the authority to require the removal of any board member, officer, or employee whom it determines has violated prohibitions against excess benefit transactions and private inurement.

➥ Increasing state and federal capacity for regulating exempt organizations. Congress would appropriate an additional $200 million to the IRS, and $25 million in matching grants to states, for regulation of tax exempt organizations. States would have the authority to bring lawsuits against such organizations based on violations of federal tax laws. A director of a tax exempt organization could sue the organization in U.S. Tax Court, or file a complaint with the IRS, if the director alleges that the organization has violated applicable laws.

None of these proposals have yet been introduced as legislation. The Finance Committee's first Roundtable discussion, held on June 21, 2004, was attended by hundreds of nonprofit executives and focused on abuses in the nonprofit community. The second Roundtable, held on July 22, 2004, was closed to the public. The approximately 100 invitees who attended were primarily nonprofit officials who submitted comments on the Discussion Draft (http://finance.senate.gov/sitepages/round.htm).

Commentators generally affirmed the Discussion Draft's tone and intent, and agreed with some of its substantive provisions. For instance, most agreed that current enforcement of tax exempt laws by the IRS and state attorneys general is inadequate, and needs to be strengthened through such means as increased funding and changes to the content and processing of Forms 990. Many of the proposed governance provisions, however, particularly the 5-year re-application requirement, were opposed at the Roundtable. Some nonprofit officials expressed concern over whether the IRS Exempt Organizations Division should be tasked with greater responsibilities when it is having difficultly monitoring existing charities and enforcing existing laws.

➥ Senator Grassley plans to introduce some of the Committee's proposals as legislation as soon as this fall. A copy of the Finance Committee's Discussion Draft is available on the ECFA web site, at http://www.ecfamembers.org/pdf/discussion_draft.pdf. To comment on any of the Committee's proposals, contact the Committee or any of its members, whose contact information is available at http://finance.senate.gov/sitepages/committee.htm.

Liability & Risk Management

AmeriCorps Program Struck Down as Establishment of Religion

A federal district court has struck down the AmeriCorps Education Award Program ("Program") on the grounds that it has the effect of advancing religion, in violation of the Establishment Clause of the First Amendment.

The Program is administered by the Corporation for National and Community Service ("CNCS"). It provides participants national service awards for completing a term of at least 1700 hours of service during a 9-12 month period. Once participants have completed this service, they receive an award of $4725 to pay their student loans or educational expenses.

The Program is administered by AmeriCorps grantees such as state and local governments and secular and religious nonprofit organizations. These grantees receive $400 per Program participant from AmeriCorps in exchange for recruiting, training, supervising, and placing Program participants. Many of these Program participants satisfy their national service requirement by teaching in Catholic schools. One of the larger grantees is the University of Notre Dame, which joined the case as a Defendant-Intervenor.

> The Court found that there was "a total blurring of religious and on-religious activities"...religious activities were ongoing and commingled with secular activities...

The American Jewish Congress ("AJC") challenged the Program's constitutionality in the U.S. District Court for the District of Columbia. On July 2, 2004, the Court held that the Program violated the Establishment Clause because:

1) The $4725 Program grants made to teachers who provided religious instruction as part of their national service *directly funded and advanced religion*. Many grantee schools required that Program participants meet certain religious criteria and participate in prayer and religious instruction. Also, the Court found that the secular and religious portions of many grantees' teaching were so closely commingled as to be inseparable, resulting in the direct funding of religion. For instance, Notre Dame required its AmeriCorps teachers to participate in prayer services, take courses on integration of faith and education, and live in "intentional Christian communities."

2) The $400 administrative grants made to religious schools did not require them to separately account for the funds or exercise sufficient oversight over their use to ensure that the funds were used for purely *secular* purposes. The Court found these grants were too closely linked with the schools' religious purposes and activities.

CNCS argued that under federal law and CNCS regulations, the Program participants in religious schools could teach religious subjects or lead students in prayer during their "free" time, and did not include this time as part of their 1700 hours dedicated to AmeriCorps-related national service. CNCS required participants

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to keep written records documenting these 1700 hours, avoid any religious prayer or instruction in these hours, and submit these records to AmeriCorps. The AJC disagreed, claiming that the lack of adequate oversight systems made it impossible for CNCS to monitor whether participants counted only "secular" teaching hours toward their 1700-hour quota.

The court agreed with AJC. Citing CNCS's apparently poor record-keeping practices, the court found that there was "a total blurring of religious and non-religious activities" when the teachers taught religion classes in the same school in which they recorded national service hours. The court noted that religious activities were ongoing and commingled with secular activities throughout the entire school day. It determined that because of this direct funding of religious activity, one could reasonably believe that the government was endorsing the teachers religious messages and "indoctrinating" students with religion in violation of the Establishment Clause.

The court's decision emphasized CNCS's failure to put adequate oversight procedures in place to ensure governmental funds were not being used for religious purposes or activities. The Court suggested that CNCS should have required a more specific accounting of the grantees' actual use of government funds. The court also suggested that it was a violation of the Establishment Clause for AmeriCorps grantees to require participants to hold specific religious beliefs or engage in specific religious practices as a condition of enrolling in AmeriCorps-funded programs.

The parties have until the beginning of September to decide whether to appeal, and Notre Dame has indicated that it will appeal. If an appeal is filed, however, some commentators believe that the court of appeals could resolve the dispute on a statutory basis, and thereby avoid the difficult constitutional questions altogether. This could limit any broader impact that the decision might have on other faith-based initiatives and related government programs that fund religious organizations. American Jewish Congress v. Corporation for National and Community Service, Civil Action 02-1948 (DDC July 2, 2004).

➥**This case raises the questions of whether and how faith-based organizations can receive and use government funds in their religious programs without violating the Establishment Clause. The AmeriCorps' case opinion underscores that religious organizations must have reasonable oversight and accounting systems in place to adequately document that government funds are being spent on purely secular instruction and activities. Before accepting government funding, religious organizations should count the administrative, legal, and ministry-related costs of doing so.**

Princeton University Sued For Diverting Donor-Restricted Funds

Heirs of the A&P supermarket fortune have sued Princeton University, claiming that Princeton illegally diverted over $100 million from a restricted fund established by their parents.

In 1961, Charles and Marie Robertson created the Robertson Foundation at Princeton and donated 700,000 shares of A&P stock, then valued at $35 million, to the Foundation. They created the Foundation to finance an expanded graduate program at Princeton's Woodrow Wilson School of Public and International Affairs. The Foundation's Certificate of Incorporation states that its purpose is to enable "men and women dedicated to public service [to] prepare themselves for careers in government service, with particular emphasis on the education of such persons for careers in those areas of the Federal Government that are concerned with international relations and affairs." The Foundation's assets have since grown to over $600 million.

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Although the Foundation is independent from Princeton, Princeton exercises effective control over the Foundation by virtue of its power to appoint a majority of the Foundation's trustees. Three of the trustees—two of the Robertsons' children and their cousin—are plaintiffs in the lawsuit filed in New Jersey Superior Court.

The lawsuit, originally filed in 2002, was recently amended to allege that Princeton has improperly and systematically diverted more than $100 million from the Robertson Foundation to various university programs outside the scope of the Foundation's mission. It also alleges that Princeton has attempted to fraudulently conceal its wrongdoing by refusing to provide Robertson family trustees with accurate documentation on Foundation programs and expenditures, and by making false representations in the Foundation's annual written reports.

The amended suit also alleges that Princeton's "donor shell game" extends to other university programs. It states, "Princeton has a pattern and practice of violating donors' conditions and improperly spending restricted gifts in ways that benefit the university's own general fund." The lawsuit cites a 2003 memo by a university employee who allegedly audited various restricted gifts for Princeton's Office of Religious Life and found Princeton had ignored the religious purposes of donors' gifts and diverted funds intended for religious life to non-religious uses.

The amended lawsuit requests punitive damages and Robertson family legal fees, and also asks that the New Jersey Superior Court:

➥ Order an amendment of the Foundation's organizing document to remove Princeton's controlling interest in the Foundation, and provide that all Foundation trustees be appointed by the Robertson family;

➥Order Princeton to return control of the Foundation's investment portfolio to the Robertson family; and

➥Order Princeton to reimburse the Foundation, with interest, for all Foundation funds that were diverted and used for improper purposes.

A statement by Princeton has accused the Robertson family of making "unsubstantiated and misleading claims."

➥This case raises important issues involving donor intent and control over gifts that donors give to charities, but designate or restrict for particular purposes. Nonprofit organizations should adopt policies regarding the acceptance and administration of such designated or restricted gifts. Among other safeguards, charities should require that any such gift be accepted only if the donor's stipulated use is consistent with the charity's tax exempt purposes. It is also advisable for the charity to retain, through a written agreement with the donor, a "variance power" to apply the gift to other uses should the charity determine that the donor's use is no longer consistent with the charity's purposes. For more information and general guidance, see Nonprofit *Alert*® Memo, *Donor Designated Gifts: Pitfalls and Provisos*. **See last page to order.**

Nonprofit and Tax Exempt Organization Issues

IRS Approves Scholarship Program Involving Student Fundraising

The IRS has ruled that scholarship payments received by seminary students who agree, as a condition of receiving the scholarships, to help raise funds to pay for the scholarship program are excludible from the students' taxable income.

The seminary's scholarship program is designed to reduce the cost of seminary education to its students who are pursuing seminary degrees, and to improve the students' theological and practical understandings of Christian stewardship. Students who receive scholarships agree to take a seminar to learn practical stewardship skills and principles and practices of fundraising / "friend-raising," then to apply those principles through fundraising and donor relations activities.

Participating students are required to secure a sponsoring church that makes a financial commitment to the scholarship program. They are also expected to provide names of potential new donors whom they will contact about providing financial support to the program. These contacts give students an opportunity to apply the stewardship-related principles they are learning in the program. The students are also expected to send thank-you letters and periodic reports to pledging donors. However, the scholarships are not contingent on the students achieving any particular fundraising targets or other goals.

The IRS ruled that the scholarships provided through the program are "qualified scholarships," which means that they are excludible from the recipients' taxable income. For scholarships to be "qualified," they cannot be given as payment for services that are required as a condition of receiving the scholarship. Here, the IRS determined that even though the scholarship recipients are expected to provide fundraising services to the seminary, those fundraising services are primarily educational in nature, as they help the students apply stewardship principles and develop practical skills. The IRS considers any benefit the seminary derives from such services to be "coincidental, insubstantial, and inconsequential." Accordingly, the IRS ruled that the scholarships are qualified and excludible from the students' taxable income. IRS LTR 200414039.

➥**This private letter ruling technically applies only to the seminary and its students, and is not binding on the IRS vis a vis any other taxpayer. Whether a particular payment constitutes a "qualified scholarship" is a very fact-specific determination. Still, this ruling suggests that nonprofits can structure their scholarship programs to require students, as a component part of their educational programs, to provide some services that practically benefit the organization. This is good news not only for theological schools, but for any other educational institution that seeks to make education more affordable for students while deriving some benefit from those students' services. For more information on the legal issues involved in offering scholarships, see Nonprofit *Alert*® Memo, *Scholarship & Tuition Reduction Programs*. Please contact Steve Clarke at smc@gg-law.com or (703) 761-5000 if your organization is considering the development of such a scholarship program.**

IRS Approves Ancillary Joint Venture Between Nonprofit and For-Profit

The IRS has issued a revenue ruling addressing a certain “ancillary” joint venture between a nonprofit and a for-profit entity.

Revenue Ruling 2004-51 poses a hypothetical scenario involving a university that offers teaching training seminars, and forms an LLC with a for-profit company that will offer the seminars at off-campus locations using interactive video technology. The LLC’s governing documents provide that the university controls all content, teachers, and completion requirements for the seminars, while the company controls the locations, administration, and marketing of the seminars. The governing documents also limit the LLC’s activities to conducting teacher training seminars, and prohibit the LLC from engaging in any activities that would jeopardize the university’s tax exemption. The university and company each hold a 50% ownership interest in the LLC, proportionate to their respective capital contributions. Each party appoints three directors to the LLC’s governing board.

The IRS ruled that this arrangement would neither jeopardize the university’s tax exemption nor result in unrelated business income tax (“UBIT”), because the LLC activities are essentially educational in nature and thus are substantially related to the university’s tax exempt purposes. It cited the university’s control over seminar content and teachers, and noted that the company’s LLC activities furthered–rather than undermined—the university’s educational purpose in distributing the seminars.

Even if the LLC activities had not been substantially related to the university’s exempt purposes, the IRS noted that the LLC would not jeopardize the university’s tax exemption because the LLC activities were an insubstantial portion of its total activities.

This is the first “ancillary” joint venture ruling issued by the IRS in the past several years involving a nonprofit that engages in a joint venture as a secondary activity rather than a primary activity.

Rev. Rul. 2004-51 is the first “ancillary” joint venture ruling issued by the IRS in the past several years involving a nonprofit that engages in a joint venture as a secondary activity rather than a primary activity. In other recent IRS joint venture rulings, the charities involved had no activities other than those involved in the joint venture. As in those rulings, the IRS suggested in Rev. Rul. 2004-51 that, to avoid UBIT, the charity must exercise sufficient control over the joint venture to ensure that it furthers the charity’s tax exempt purposes. However, the IRS did not indicate what minimal level of control by a charity is needed to ensure that the venture’s activities further exempt purposes. The IRS makes such decisions on a case-by-case basis. A “safe harbor” level of control would involve the nonprofit appointing a majority of the directors/trustees of a joint venture. To read this Revenue Ruling, click on http://www.irs.gov/pub/irs-drop/rr-04-51.pdf.

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Communications Law Developments

FCC to Auction Open FM Spectrum

The FCC will be accepting applications in August and conducting an electronic auction in November for new commercial radio stations on 290 vacant allotments on the FM dial across the United States. Applications for the new stations are due on August 6, 2004. Nonprofit entities may file applications for new commercial frequencies, on which they could either operate commercial or non-commercial stations. However, a nonprofit would not be allowed to participate in the auction for a station if a mutually-exclusive application for the stations is filed by a for-profit entity. If multiple nonprofits (but no for-profits) apply for the same station, the FCC would use its comparative selection criteria to award the license. To see a description of application and auction procedures, click on http://wireless.fcc.gov/auctions/37

Legal Wake-Up Call Seminar Announced

Nonprofit leaders are invited to join us for our Legal Wake-Up Call at Gammon & Grange's offices in McLean, Virginia, on Wednesday, September 15, 2004, from 7:30–10:30 a.m. This is an informational breakfast seminar to discuss two relevant nonprofit-related legal issues: Lobbying and Political Activity by Nonprofits, and Your Nonprofit's Website. If you are interested in attending, please RSVP to jsh@gg-law.com or call 703-761-5000. Directions to our office are available on our web site, at www.gg-law.com. If you are unable to attend but would like to be on our e-mail list, please let us know.

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