



Nonprofit *Alert*[®]

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

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Charity Reform Outlook Uncertain in New Congress as IRS Forges Ahead

After passing the most extensive round of charitable reform laws in over a decade as part of the Pension Protection Act of 2006 (PPA 2006), Congress is giving few clues about whether it will continue to consider similar measures under its new Democratic leadership. The push for charitable reform in recent years was spearheaded by Senator Grassley, who used his Finance Committee chairmanship as a “bully pulpit” to investigate charities, spotlight perceived “abuses,” and advocate legislation to stamp out the most egregious forms of abuse. While Grassley’s counterpart on the House Ways and Means Committee, Rep. Bill Thomas, was generally less critical of charities, Thomas did conduct hearings focusing on abuses among nonprofit hospitals and credit unions.

Whether the new Democrat-led Congress will continue to call for significant reform is unclear. The two new leaders of the Senate Finance Committee and House Ways and Means Committee have not addressed their intentions thus far this term. In past years, the new Senate Finance Chairman, Max Baucus, warmly supported Grassley’s initiatives but was less vocal in his criticism of the charitable community. Some Hill insiders are reporting that charitable reform is not one of Baucus’ priority items. Last year, new Ways and Means Chairman, Rep. Charles Rangel issued a public statement expressing his reluctance to support increased regulation of charities without more evidence of widespread abuse.

➔ In the meantime, the IRS has stayed busy by providing its interpretation of certain charitable reform measures in the PPA 2006. On December 4th, the IRS provided interim guidance on several aspects of the supporting organization and donor advised fund reforms in PPA 2006.

On January 10th, the Treasury Department and the IRS issued guidance on the IRA charitable rollover provision in PPA 2006, including clarification that:

- married individuals filing a joint return who are at least age 70 ½ can transfer up to \$100,000 each from their IRAs to eligible charities, and
- IRAs held on behalf of beneficiaries (after the death of the original owner) are eligible for the rollover provision so long as the beneficiary is at least 70 ½ years of age.

On January 12th, the IRS also published special instructions for providing required information under certain PPA 2006 provisions in conjunction with the filing of 2005 Forms 990, 990-EZ, 990-PF, 990-T and 4720. Since the 2005 forms and instructions will not be changed to reflect these reporting requirements, exempt organizations will want to review the special instructions at <http://www.irs.gov/charities/article/0,,id=166019,00.html>. The instructions correlate with PPA 2006 provisions related to supporting organizations, organizations sponsoring donor advised funds, and organizations with controlled entities.

As the Treasury Department and the IRS issue further guidance, including regulations on PPA 2006, we will provide you with updates.

Ministerial Exception Upheld in ADA Claim.

A former employee sued a church-affiliated hospital, alleging that her termination from the position of resident in a clinical pastoral education program violated the Americans with Disabilities Act ("ADA"). The Sixth Circuit Court of Appeals has affirmed a lower court decision dismissing the complaint based on the ministerial exception.

The ministerial exception, a doctrine rooted in the First Amendment's guarantee of religious freedom, limits legal jurisdiction over claims involving the employment relationship between a religious institution and its ministerial employees, based on the institution's constitutional right to be free from judicial interference in the selection of those employees.

For the ministerial exception to bar an employment discrimination claim, the employer must be a religious institution and the employee must be a ministerial employee. But, in order to invoke the exception, an employer need not be a traditional religious organization such as a church, diocese, or synagogue. The exception has been applied to claims against religiously affiliated schools, corporations, and hospitals. The Court in this case held that a religiously affiliated entity is considered a 'religious institution' for purposes of the ministerial exception "whenever that entity's mission is marked by clear or obvious religious characteristics."

As a general rule, if the employer is a "religious institution," the ministerial exception will be invoked if "the employee's primary duties consist of teaching, spreading the faith, church governance, supervision of a religious order, or supervision or participation in religious ritual and worship." The Sixth Circuit agreed that a ministerial employee need not necessarily be ordained. The plaintiff in this case, although not ordained, filled a pastoral role at the hospital. Thus, the plaintiff's claim under the ADA could not be maintained.

Property Tax Exemptions Come Under Scrutiny in Big City Markets

A recent Illinois state action to revoke the property tax exemption of a prominent nonprofit hospital has called attention to the clash between nonprofit groups and city governments when valuable property tax dollars are at stake. The Provena Covenant Medical Center in Urbana lost its property tax exemption when the state determined that its charitable expenditure, less than 1 percent of its total revenue, was insufficient to justify the \$1.1 million it was saving in property taxes. This decision is currently under appeal.

Other private hospitals and nonprofit organizations occupying prime real estate are starting to realize that they too are becoming more attractive sources of revenue to cash strapped municipalities looking to raise funds without raising taxes. The potential value of these tax exemptions to local govern-

ment is staggering. Take, for instance, the Gherty Museum, sitting atop 110 acres of posh ocean front property which represents a \$18.4 million tax loss to the City of Los Angeles, or the Chrysler building whose 77 stylish floors are nonprofit owned, equaling a \$17.5 million loss to New York City.

The significance of these losses depends on the city's reliance on revenue generated by property taxes. In New York, although total nonprofit property value exceeds \$11.9 billion, the corresponding tax loss relative to the city budget only amounts to 1.6%. Boston, on the other hand, relies far more heavily on property taxes. The value of exempt property in Boston totals almost \$8 billion, and represents 11.6% of the total city budget.

In response, some cities and states are considering tightening the requirements for property tax exemption to make it harder for organizations to qualify. Like Illinois, these states would require more demonstrable proof of an organization's charitable activities. Other cities are requiring nonprofits to pay fees for municipal services like trash collecting and police protection. Either way, it appears that nonprofit organizations are going to have to start making more direct contributions to local governments in spite of their charitable status.

Court Affirms No Expectation of Privacy in Workplace Computer

The Ninth Circuit Court of Appeals recently upheld a lower court decision that an employee did not have an expectation of privacy in his workplace computer sufficient to suppress images of child pornography sought to be admitted into evidence in a criminal prosecution.

Although the employee had to use his individual log-in to access the workplace computer, personnel from the employer's internet technology (IT) department had complete administrative access to all employees' computers. Additionally, the employer prohibited private use of computers by employees, the employer had installed a firewall that monitored employees' internet traffic on workplace computers, the IT department reviewed a log created by the firewall on a regular basis, and employees were apprised in training and in the employment manual of employer's monitoring efforts.

"Employer monitoring is largely an assumed practice, and thus we think a disseminated computer-use policy is entirely sufficient to defeat any expectation that an employee might nonetheless harbor."

➔ This case reaffirms the rights of employers to monitor use of company computers by employees. However, to counter any claim that an employee has an expectation of privacy, the employer should clearly communicate its computer monitoring policies.

Big Changes are on the Way for the Beleaguered American Red Cross

“After a six-month long comprehensive review,” an American Red Cross press release reports, “the Board has unanimously approved transformational changes to its role, size and composition, and other significant governance practices.”

Crafted by an independent committee of academic, business and charity leaders, the planned revamp signals the first major change in the Red Cross’s governance structure in almost 60 years—the last comprehensive overhaul of the organization’s Congressional charter was in 1947—and has come about primarily as a response to criticism of the charity’s response to recent disasters.

Upon congressional approval, the following changes to the organization’s management will be phased in over the next six years:

- The size of the board will shrink from 50 members to no more than 20.
- Board structure will be simplified with several board committees eliminated, and the executive committee’s role reduced.
- Two advisory councils, one made up of government representatives appointed by the President of the United States, and the other of delegates from local chapters, will advise the board.
- The board will consider appointing an ombudsman to serve as a voice for whistleblowers.

Critics of the plan argue that it does not do enough to repair the organization’s damaged reputation and to regain the public’s trust. Others claim that the proposed changes will not be fully implemented quickly enough.

➔ For an overview of nonprofit director’s responsibilities, order Gammon & Grange’s **Nonprofit Alert Memo, Director’s Nonprofit Legal Duties**.

A New Report is Shedding Light on Nonprofit Accountability Practices in Light of the 2002 Sarbanes-Oxley Act (SOX)

The report, “Nonprofit Governance and the Sarbanes-Oxley Act,” which is available free online at <http://www.urban.org/url.cfm?id=311363> and <http://boardsource.org/sarbox>,

found that making some of the provisions of SOX mandatory for nonprofits (currently, most SOX provisions are only applicable to publicly traded companies) would require “substantial numbers of groups to alter their practices.” But imposing other SOX requirements “would result in little change because most are already in voluntary compliance.”

The report analyzed responses of a survey conducted by the Urban Institute. As an example, the survey inquired about the SOX requirements that audit committees be directly responsible for hiring and overseeing external auditors, and that companies disclose if audit committees have at least one financial expert.

The report found that only 20% of all nonprofit groups had separate audit committees, which was “the least commonly accepted practice related to Sarbanes-Oxley issues in all size groups.” Only the group of nonprofits with over \$40 million in annual expenditures had a majority of organizations with an audit committee. A great majority of nonprofit organizations that did have audit committees had at least one financial expert on the committee, and most had created or revised the committee since 2002, findings which support the thesis that passage of SOX spurred many nonprofits to reexamine and revise their practices.

Overhead Limitation Dropped from CFC Requirements

The U.S. Office of Personnel Management, which oversees the annual Combined Federal Campaign government fundraising program, has dropped a requirement that generally limited eligible participants’ combined administrative and fundraising expenses to no more than 25% of total revenue. The 25% overhead ceiling had become a drain on OPM resources, as this requirement was frequently challenged by charities.

IRS Information Letter Regarding LLC Subsidiaries of Exempt Organizations

The IRS recently issued a form information letter for exempt organizations seeking guidance on the tax treatment of LLCs in which the exempt organization is the sole member. The IRS reiterated that an LLC with a single member is disregarded for federal tax purposes unless it elects to be regarded separately from its member. The disregarded LLC receives the benefit of its member’s tax-exempt status, and the exempt organization member must treat the operations and finances of the LLC as its own for Form 990 filing purposes. A disregarded LLC may choose to report and pay employment taxes for its employees separate from its sole member, and may, but is not required, to obtain its own employer identification number (which would only be used for reporting and paying employment taxes).

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IRS Letter...continued

The sample information letter also notes that the organizational documents of the disregarded LLC do not have to contain specific language limiting the LLC's purposes to one or more tax exempt purposes. However, the exempt status of the member may be affected if the LLC's organizational documents contain purposes that are contrary to the tax-exempt purposes of the member.

Substantiation of Payroll Deduction Contributions

The IRS has issued a notice regarding the applicability of new contribution substantiation requirements to contributions made by payroll deduction. The 2006 Pension Protection Act ("PPA") added Section 170(f)(17) to the Tax Code, which provides that charitable contributions made by cash or check, and other monetary contributions are not deductible unless substantiated by bank record or a written communication from the donee organization showing the donee's name, the date of the contribution, and the amount of the contribution.

In Notice 2006-110 the IRS has indicated that in the case of payroll deduction contributions, a donor satisfies the substantiation requirements of Section 170(f)(17) if the donor has both (1) a pay stub, Form W-2, or other document furnished by the employer that sets forth the amount withheld during a taxable year by the employer for the purpose of payment to a donee organization, and (2) a pledge card or other document prepared by or at the direction of the donee organization that shows the name of the donee organization. For contributions of \$250 or more, the pledge card or other document prepared by the donee organization must also include a statement to the effect that the organization does not provide goods or services in consideration for any contributions made to the organization by payroll deduction.

More EOs Required to File 990s Electronically

With the new year, the number of exempt organizations that are now required to file their annual IRS Form 990 returns electronically has increased. For tax years ending on or after December 31, 2006, organizations with at least \$10 million in total assets and that file at least 250 returns in a calendar year (including employment tax and information returns) must file the Form 990 electronically.

IRS Backlog on Form 1023 Applications

The IRS is experiencing record backlogs in processing Form 1023 applications for recognition of 501(c)(3) exempt status. Most applicants are waiting six to nine months for approval of their applications, with complex applications taking significantly longer. However, applications that are

approved at the initial screening phase are generally approved within three months of submission.

IRS Website Guidance on EO Employment Tax Responsibilities

Exempt organizations may find several helpful resources regarding federal employment tax obligations on the IRS website at www.irs.gov/charities/article/0,,id=128716,00.html

IRS Internet Workshops

The IRS has launched a virtual exempt organization compliance workshop aimed at small and mid-sized organizations that do not have tax experts on staff. The workshop contains five interactive modules on the following topics:

- Tax-Exempt Status – How can you keep your 501(c)(3) exempt?
- Unrelated Business Income – Does your organization generate taxable income?
- Employment Issues – How should you treat your workers for tax purposes?
- Form 990 – Would you like to file an error-free return?
- Required Disclosures – To whom do you have to show your records?

The online workshop can be accessed at www.stayexempt.org. No registration is required and users will remain anonymous.

To Order Memos: Memos referenced in the *Nonprofit Alert* can be purchased for \$20 each (\$10 for clients) from Gammon & Grange, P.C. Five or more copies of the same memo are bulk priced at \$5 each. Visit the [Nonprofit Alert Memo Page](#) for details.

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