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Nonprofit *Alert*®

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

Inside This Issue:

IRS Policy Now Protects Donor Privacy

Responding to pressure from practitioners, the IRS says it now has in place a series of steps designed to protect donor privacy. Confusion about the IRS's information release policy and interpretations of that policy, which varied between IRS offices, led to recent criticism from practitioners and donors alike.

Steps to Protect Privacy

The IRS will now exclude from electronic disclosure Schedule B (i.e. the report form attached to Form 990 that lists contributions a charity receives). Printed copies of Schedule B's will be available only upon request and only in redacted form with much of the donor identification-related material will be removed.

The IRS says its Service reviewers will consider what information to redact on a case-by-case basis anytime a request is made for a particular charity's Schedule B. Any information that could "clearly identify" a donor will be removed.

This new policy means that charity watchdog groups and web sites like Guidestar won't likely have full postings of all charity Schedule B's as they have had in the past, although the remainder of Form 990's and other tax documents will still be available.

These restrictions are necessary to protect the privacy of charities and donors, especially if a charity's adversaries attempt to use donor information to dissuade contributions or draw public attention to donors who want to remain anonymous.

> "We are mindful...that some donors prefer to give anonymously. We are also aware that Internet access...gives urgency to this concern." – *Steven T. Miller, Director, IRS Exempt Organizations Division.*

Confusion and Inconsistency

The debate over donor privacy began in 2000 when the IRS published Schedule B with a note saying that the information contained on the form was "not open for public inspection."

However, the IRS's Ogden, Utah Service Center reportedly released all information contained on the Schedule B except for donors' names and addresses. Certain other data on some forms was withheld at the discretion of the IRS Ogden staff.

In 2001, the IRS revised the Schedule B instructions with a note saying that *all* information provided on the form would be subject to public inspection except for data that identified donors, such as names and addresses. No additional guidance was provided as to what other information the IRS might consider as "identifying" donor data.

IRS officials said the proliferation of charity and donor information now available on the Internet gave "urgency to this concern" and helped solidify the new policy. It is effective immediately.

New Political Guide for Religious Groups

The Pew Forum on Religion has just published a new guide detailing what religious groups can and cannot do in the political arena. The 20-page booklet covers topics such as voter education, candidate forums, and issue advocacy. It's available free by calling (202) 955-5075 or download as a pdf file from the Forum's web site at http://www.pewforum.org.

Liability & Risk Management

Nonprofit CEO Spouse Equals Disqualified Person; Consulting Fees Must Meet Excess Benefit Test

The wife of a nonprofit health care group's CEO is a disqualified person under the tax code definition, the IRS has determined, thus all the payments she receives from the nonprofit for her consulting services are subject to an excess benefit analysis under the IRS intermediate sanctions rules. The case involved a husband and wife who entered a consulting contract with the nonprofit, which was to take effect when the husband's position as CEO ended. The agreement required both individuals to represent the nonprofit at various events, help with fundraising, manage specific projects, serve on the board, and communicate frequently with the nonprofit's leaders. The husband would receive 60% of the compensation, and the wife would receive 40% under the contract. An independent firm, hired to analyze the compensation package, certified to the board that the pay was reasonable. However, that certification came nine months after the board had already approved the contract with the CEO. A few years later, the original contract was amended but was never analyzed again for reasonableness. The IRS ruled that the board's actions fell short of the requirements for the rebuttable presumption of reasonableness (i.e. the tax code provision that presumes a compensation agreement is reasonable if the board takes certain steps during formulation of the agreement) because it failed to document appropriate comparability data. Regarding the wife's consulting payments, the IRS said the total value of her services had to be compared to the compensation she received in determining reasonableness. It didn't matter that one contract covered compensation to both the husband and wife. Since both were disqualified individuals, the value of the services that each performed individually—not the value of the services they performed as a unit—should be analyzed separately for excessive benefits, the IRS concluded. IRS TAM 200244028.

> **Even where disqualified persons perform as a team, it's the value of their *individual* service that matters for excess benefits analysis.**

This case warns any nonprofit executive whose family members work in the same nonprofit that intermediate sanctions cover family. Therefore, compensation packages must be closely scrutinized for all family members. Learn more in Nonprofit Alert® Memo, *Intermediate Sanctions Law.* See back page to order.

Board Slapped with $600,000 in Whistleblower Suit; Discrimination and Defamation Charges Dismissed

The Alaska Supreme Court has affirmed an award of $600,000 to a whistleblower who sued because she was fired and defamed for reporting her concerns about misappropriation of funds by the president of a nonprofit economic development corporation. The employee was originally hired on a one-year contract to fill in for the controller who was on sick leave. Once on the job, she received reports from other employees about possible theft of funds. She shared the reports with the association president, but he refused to investigate further. A few months later, she discovered evidence of misappropriation by the president. She shared this information with two board members who told her she had authority to investigate further and report to the association's attorney. The next day, the president sent the employee home and convened the board, which voted to suspend the employee without pay. The president also contacted officials in the state office and told them that the employee was fired because she had falsely accused him of misappropriating funds. The state office then sent an email summary of the incident to all state officers and industry members. At the same time, however, the association's board ordered an audit, which later turned up evidence to substantiate the employee's claims. After receiving the audit report, the board offered her a new position, but she refused and filed suit. A lower court sided with her, and the state supreme court upheld, finding the association "effectively shut her out of [her] career field." *Central Bering Sea Fishermen's Assoc. v. Anderson,* No. S-9955, No. 5623 (AK 2002).

> **When trouble knocks, be careful before you fire the messenger.**

When bad news knocks, slamming the door is rarely the right response. A reporting mechanism that went directly to the board chair would have been a useful part of this association's conflicts of interest policy. A proactive investigation would have been even more advisable. An annual audit would also help, especially if the auditors report to the board's audit committee, not senior management. For guidance on engaging your auditors and conducting the exit interviews, see Nonprofit *Alert*® Memo, *Annual Audits: Vital Risk Management.* To order, see page 4.

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Employees & Volunteers

FMLA Claim Nets $11.6 Million for Parental Care

A Chicago court has awarded $11.65 million to a hospital employee who was discriminated against for taking time off to care for his elderly parents. Chris Schultz, a 25-year veteran at the hospital, won performance awards and posted a stellar employment record. In 2000, he requested time off under the Family & Medical Leave Act (FMLA) to care for his father, who had Alzheimer's, and his mother, who was gravely ill. She died a few months later. At this same time, the hospital began evaluating employees based on work completed during a specific period. Schultz's performance suffered under this new system since he was absent for most of the time during which he was evaluated. His poor performance appraisals throughout the year eventually led to his dismissal. He then filed suit against the hospital, alleging discrimination and retaliation for taking FMLA leave. A jury found the hospital liable for $10.75 million and two supervisors liable for $450,000 each in damages. *Schultz v. Advocate Health,* No. 01C-0702 (N.D. Ill. 2002).

The potential for more parental care cases is increasing significantly as the population ages. Not disciplining or demoting employees while they are on FMLA leave apparently bears repeating. FMLA requires leave without job penalty. Consult counsel before taking any action that could negatively impact anyone on FMLA leave. To check your organizations' FMLA policies against a legal base line, read Nonprofit *Alert*® Memo, *FMLA Compliance.* See back page to order.

Sick Leave Exchange Program Benefits Employees While Avoiding Tax Consequences

Contributions that a charitable organization makes to its sick leave exchange program on behalf of employees won't constitute taxable income to those employees, the IRS has ruled. The charity set up a program that met all the requirements for a discretionary defined contribution plan under the tax code. One aspect of that plan called for the charity to exchange sick leave for cash payments to employees who were hired before 1996 and who had accumulated 30 days or more of sick leave. Employees could elect to take the payments or retain the leave if they remained employed with the charity until retirement. The IRS ruled that the plan would not create actual or constructive income to the employees who elected payments instead of leave. The IRS also said the charity's payments would not be subject to FICA taxes because the payments represented "a nonelective employer contribution rather than a cash or deferred election." IRS LTR 200247050.

Unintended tax consequences should be considered anytime a charity offers new employee programs or benefits. In this case, the benefit didn't result in additional tax liability for employees, but such plans must be carefully structured to avoid unintended taxation. Consult experienced counsel before modifying employee benefits.

NPA Highlight of the Month

States Working to Simplify Online Sales Taxes

State taxing authorities have long fretted over losing sales taxes from online purchases—to the tune of $13.3 billion last year, according to a University of Tennessee study—but that may soon change. Last fall, representatives from 33 states signed onto an agreement that sets standards for state sales tax administration, including sales taxes applied to online transactions. The agreement adopts uniform definitions describing exactly what goods and services are taxable, and it specifies the use of three systems for retailers to use in collecting and reporting sales taxes. Retailers could pick one of the three systems and know they are in compliance with state collection requirements.

The initiative is part of the Streamlined Sales Tax Project (SSTP), a 40-state coalition led by Utah Governor Michael Leavitt. The goal is to implement a simplified system that reduces the number of sales tax rates and lessens the burden of tax collection on retailers. Thanks to new technology that modernizes many administrative aspects of sales tax collection, significant improvements in the retail industry have been made in recent years. That same technology holds potential for bringing uniformity to online sales taxes. The SSTP launched a pilot project early last year to test the collection mechanisms that later became part of the three systems formalized in the agreement. More capabilities and greater applications are yet to come, experts say, as technology improves.

Under the SSTP agreement, state legislatures now must adopt legislation that implements the provisions of the agreement. No part of the agreement is binding on any of the 33 state signatories until at least 10 states, comprising 20% of the total population of states with a sales tax, adopt the legislation. Although retailers are not legally required to collect and remit sales taxes for a state unless they have a physical presence there, what constitutes "presence" is not altogether clear in an e-commerce sense. Thus, given the simplication of administering sales tax collection, states are hoping that some retailers elect to participate in this new collection system even if their legal obligation to collect in particular states is questionable.

Sales taxes apply in 45 states and the District of Columbia. More than 7,500 cities and towns across the nation levy additional sales taxes. Some jurisdictions may exempt nonprofits from sales tax collections; others do not. In general, nonprofits are responsible for collecting and remitting sales taxes on items sold that are not exempt from taxation in jurisdictions where the nonprofit maintains a "presence." While rates and collection procedures will continue to vary, this effort by the states is at least a positive step toward simplifying the sales tax maze. Read more about the agreement at http://www.streamlinedsalestax.org.

Tax-Exempt Issues

Protestant Donations Rise, But Social Gifts Drop

The amounts that Protestant donors give to churches is on the rise, but less of their donations are earmarked for church-sponsored social services programs, a new study reveals. Protestant donors gave on average $622 per person in 2000, the year for which data was most recently available. That figure represents just 2.64% of an average donor's annual income, but it's the highest percentage reported since 1983. The data also indicates what the researchers said was a disturbing trend: only 15 cents of every dollar donated were earmarked for church-sponsored social service programs such as soup kitchens and foreign missions. Most donations were given directly to church coffers where they were used for building projects, administrative expenses, and local charitable work. The distinction between earmarked funds suggests that donors tend to give more to projects in which they personally see results. Empty Tomb, anIllinois research organization, compiled the report by reviewing charitable giving data from 29 Protestant denominations over a period of 32 years.

Copies of the report are available for $26 from Empty Tomb, (217) 356-9519. A summary of the report is available at the organization's web site, http://www.emptytomb.org.

Virginia Amends Property Tax Exemptions

Voters in Virginia have approved a constitutional amendment that limits the channels through which nonprofit organizations in the state can receive property tax exemptions. Previously, the constitution allowed both local governments and the state legislature to reorganize and grant exemptions to nonprofits that meet the exemption requirements under the state constitution and statutes. Now, under the constitutional amendment, only local Virginia governments can confer property tax exemption on nonprofits. The state legislature retains power to enact all laws affecting nonprofits, but the amendment effectively moves exemption authority to localities.

Ordering Information: Memos referenced in the ***Nonprofit Alert*** can be purchased for $20 each ($10 for firm clients) from Gammon & Grange, P.C. Five or more copies of the same memo are bulk priced at $5 each. Call, write, or email us at the address below. **Subscription Information:** Subscriptions to the ***Nonprofit Alert*** are $75/year, $130/two years. Additional subscriptions to the same organization are $25 each/year. Subscriptions for 100 or more may qualify for additional bulk discounts. Contact: Editor, ***Nonprofit Alert***, 8280 Greensboro Dr., 7th Floor, McLean, VA 22102-3807; (703) 761-5000; npa@gandglaw.com.

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