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# Nonprofit *Alert*®

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

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### *Proposed Legislation From Multiple Sources Would Expand Nonprofit Regulation*

The winds of tax exempt regulation continue to swirl around Capitol Hill. Following up on its proposals to significantly proliferate legislation governing tax exempt organizations, the Senate Finance Committee ("SFC") has announced that it will hold a hearing on April 5 to focus on abuses by such organizations and proposed legislation to address the abuses. Meanwhile, the Panel on the Nonprofit Sector ("Panel") and the Joint (Senate/House) Committee on Taxation ("JCT") have each weighed in on the proposed legislation.

As reported in the August / September 2004 **Nonprofit *Alert*®,** the SFC held hearings last summer focusing on abuses by charities regarding donations, compensation, finances, and other accountability issues. The SFC followed these hearings by requesting that the Independent Sector convene the Panel to make recommendations to the SFC regarding legislative proposals and actions to curb alleged "rampant" abuses. On March 1, 2005, the Panel published an Interim Report that supported the SFC's more benign recommendations, but deferred judgment on the more controversial proposals until a yet to be released Final Report. Among the SFC's recommendations that would likely facilitate better enforcement of existing laws, and which the Panel supports, are:

> "many of the SFC proposals are very intrusive, and would impose regulatory burdens on the nonprofit sector that are widely disproportionate to the alleged regulatory benefit."

- Mandatory electronic filing of all Form 990 returns;
- More assertive enforcement of existing penalties on organizations and / or organization managers who fail to file complete and/or accurate Form 990 returns;
- Requiring an organization to secure annual *audits* of its financial statements and operations if its annual revenues exceed a specified amount (the SFC has proposed a $250,000 threshold, and the Panel proposes a $2 million threshold); and
- Requiring *review* of an organization's financial statements by an independent CPA if revenues exceed a lower threshold (the SFC has proposed a threshold of at least $100,000 but less than $250,000, and the Panel proposes a threshold of between $500,000 and $2 million).

Unfortunately, many of the SFC proposals yet to be evaluated by the Panel are very intrusive, and if enacted would impose regulatory burdens on the nonprofit sector that are widely disproportionate to the alleged regulatory benefit. More significantly, if even some of the more onerous provisions are adopted, they will severely steepen the regulatory slope for organizing and operating exempt organizations. Among these proposals are:

- Requiring exempt organizations to refile, on the fifth anniversary of the IRS's determination of their tax exempt status, sufficient information for the IRS to determine whether they continue to be organized

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## *Proposed Legislation.....continued from page 1*

and operated exclusively for tax exempt purposes;
- Restrictions on the size of an exempt organization's governing board (*i.e.*, between 3 and 15 members);
- Requiring each Form 990 to include a detailed description of an organization's annual performance goals and measurements for meeting those goals; and
- Requiring exempt organizations to go through an accreditation process.

The testimonies and written statements presented at the SFC's June 22, 2004 hearing cited 96 abuses by nonprofit organizations. A Gammon & Grange study found, however, that current laws and regulations already govern all but 2 of the 96 cited abuses. These abuses range from general descriptions of perceived problems to specific incidents of charity abuse, and may be generally distilled into the following 10 categories:

1. Private Inurement or Benefit: 53 of the 96 cited abuses
2. Excessive Compensation: 26 of the 96 cited abuses
3. Organized for Non-Charitable Purposes: 15 of the 96 cited abuses
4. Donor Abuses: 6 of the 96 cited abuses
5. Inadequate Boardsmanship: 15 of the 96 cited abuses
6. Abusive Tax Shelters: 14 of the 96 cited abuses
7. Improper Withholding: 1 of the 96 cited abuses
8. Charities in Economic Distress: 2 of the 96 cited abuses
9. Novel Problems: 2 of the 96 cited abuses
10. Miscellaneous Abuses: 16 of the 96 cited abuses

The two novel problems identified in the hearings that do not appear to be addressed by current law are: (1) IRS employees are prohibited from sharing information with state charity regulators, thereby making enforcement of laws governing exempt organizations more difficult; and (2) according to the National Committee for Responsive Philanthropy ("NCRP"), only 12% of the grant dollars given away by the 100 largest U.S. private foundations in 2002 were for general / operating support for charities, as opposed to restrictive, program-specific grants. The NCRP believes that at least half of foundations' grant dollars should be designated for general / operating support.

In addition to the legislation proposed by the Panel and the SFC, the JCT has issued a 400-page proposal, "Options to Improve Tax Compliance and Reform Tax Expenditures," with just over 100 pages devoted to proposals to increase regulation of nonprofits, including the following:

- Every five years, each tax-exempt organization would be required to submit documentation to the IRS to confirm that it continues to be organized and operated exclusively for exempt purposes, and upon review, the IRS would permit or deny continued tax-exempt status; and
- Organizations would no longer be able to establish a rebuttable presumption of reasonableness in self-dealing transactions involving the organization and its directors, officers, and other insiders; rather, more authority would be conferred on the IRS to investigate such transactions and impose "Intermediate Sanctions" excise taxes, which the JCT proposes to increase.

Such proposals suggest a growing momentum and consensus for increased federal oversight of nonprofits. While none of these proposals have been converted into official legislation, it is quite possible that draft legislation, probably piecemeal in nature, will be proposed after the Senate Finance Committee's April 5 hearing.

The Senate Finance Committee's initial recommendations may be viewed at www.ecfamembers.org/pdf/discussion_draft.pdf. The Panel's recommendations may be viewed at www.NonprofitPanel.org, and the JCT recommendations may be viewed at www.house.gov/jct/s-2-05.pdf (see Part VIII, pp. 225-337).

**Gammon & Grange is partnering with several faith-based nonprofits to respond to these legislative proposals affecting nonprofits. This TRUST (Tax Restraint Ultimately Serves Trust) Coalition believes that new laws would only be appropriate if they make it easier for nonprofits to adhere to, and the IRS to enforce, existing laws. The Coalition believes that the proper role of government in this arena is encouraging transparency, full disclosure and accountability, and not overburdening the growth of the charitable community. If your organization is interested in joining the TRUST Coalition or has questions about the Coalition, please contact Stephen Kao at ssk@GG-Law.com or Timothy Obitts at tro@GG-Law.com. Both may be reached at (703) 761-5000.**

## *CARE Act Reintroduced; Bush Administration Drops Support for Non-Itemizer Deductions*

Unlike the legislative proposals by the JCT, Panel, and SFC to govern nonprofits, the Charity Aid, Recovery, and Empowerment Act ("CARE Act") has been introduced (actually re-introduced after dying in the previous Congress) in the Senate by Rick Santorum (S-Pa.), a tireless supporter of the bill. Once again, the CARE Act would allow tax-free distributions from IRAs for charitable purposes, charitable deductions for contributions of food inventories, and charitable deductions for non-itemizers, among other incentives to spur charitable giving. Single tax filers who use the standard deduction could deduct charitable contributions over $250, up to a $500 ceiling, while joint filers would be allowed to deduct contributions over $500, up to a ceiling of $1,000. Similar legislation is expected to be proposed in the House of Representatives in the coming months.

Down Pennsylvania Avenue, the Bush administration no longer supports the CARE Act provision that would allow non-itemizers to take charitable deductions. James Towey, head of the White House Office of Faith-Based and Community Initiatives, said the administration doesn't think sufficient support for the measure exists in Congress, and that nonprofit leaders have "mixed feelings about what the non-itemizer [deduction provision] might mean to charities." Mr. Towey made this statement shortly before the United Way issued a statement in favor of the non-itemizer charitable deduction provision, suggesting that the provision could spur a $217 million increase in contributions to the United Way alone.

The President's proposed budget does include several of the charitable giving incentives of the CARE Act, including the tax-free IRA charitable distribution provision. The Bush budget also shifts substantial social service funds from federally-run programs to faith-based and community social service organizations. For instance, the budget cuts $50 million from a Justice Department program designed to keep children from joining gangs, and allocates $50 million to a new, similar program that would be financed through the Compassion Capital Fund and make grants to religious and other grassroots charities. The President's budget also would cut 48 federal educational programs, while allocating an additional $52 million for "school choice" programs that would enable low-income parents to send their children to private rather than public schools.

## *NAACP Refuses to Cooperate With IRS Audit*

In continued defiance of the IRS, the National Association for the Advancement of Colored People ("NAACP") is refusing to provide the IRS with documents regarding a 2004 speech by the NAACP board chairman, Julian Bond, that criticized President Bush. The IRS is in the midst of an audit of the NAACP to determine whether it engaged in prohibited political campaign activity during the campaign. In response to the NAACP's refusal to provide the requested documents, the IRS has referred the matter to the Justice Department for investigation.

As reported in the January / February 2005 **Nonprofit *Alert*®**, Julian Bond criticized the Bush administration's policies on education, the economy, and the war in Iraq in a speech he made last fall. In that speech, Bond also encouraged NAACP chapters to redouble their efforts to get voters to the polls. "If whites and blacks vote in the same percentages as they did in 2000, Bush will be re-defeated by three million votes," Bond said.

In a January 14, 2005 letter, the IRS asked the NAACP to provide the names and identities of board members who authorized Mr. Bond's speech, minutes of Board meetings in which the Board resolved to distribute copies of the speech, and related information. The NAACP refused to provide any of the requested information. Its lawyers, including former IRS Exempt Organizations Chief Marcus Owens, explained that the IRS can only audit an organization's alleged political activity for a given year after the organization files its tax return for that year, unless the IRS suspects that the organization has engaged in activities that "constitute a flagrant violation of the prohibition against making political expenditures." The NAACP contends that the IRS could not have met this standard, as Mr. Bond merely disagreed with the President's policies, but did not advocate his defeat in the election. The NAACP also charges that the IRS audit was politically motivated.

Approximately 12 nonprofit organizations, including the NAACP, contended earlier this year that the federal government has used reviews, audits, and investigations to discourage them from challenging government policies. In response, IRS commissioner Mark Everson asked the Inspector General of the Treasury Department to review the IRS's process of determining which groups to investigate for pro-

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## *NAACP.....[continued from page 3]*

hibited political activity. The Inspector General has concluded that of the 40 IRS investigations it had studied, 18 involved "pro-republican" organizations, 12 involved "pro-democratic" organizations, one involved a "pro-green" organization, and the other nine investigations were of organizations without a clear political affiliation. The Inspector General concluded that the IRS followed a consistent process in reviewing allegations of political activity, and that it didn't demonstrate any political bias in its selection of charities to investigate.

➥**Section 501(c)(3) exempt organizations are absolutely prohibited from engaging in political campaign activities, though they are permitted to engage in a *non-substantial* amount of lobbying. These restrictions do not limit such organizations' ability to educate the public about political issues, so long as such education does not involve lobbying or campaigning. For an overview of the legal restrictions on a nonprofit's participation in political activity, see *Nonprofit Alert*® Memo, *Nonprofit Lobbying and Political Activity–Know Your Limits*. Please contact Steve King at (703) 761-5000 or www.gg-law.com for any specific questions regarding IRS rules on political activity.**

## *Court Approves AmeriCorps Funding of Volunteers in Religious Schools*

A federal appeals court has ruled that the AmeriCorps national service program, run by the Corporation for National Service ("CNS"), may continue making grants to participants in the program, and to both the religious and secular organizations that train and place participants.

The program requires participants to perform 1700 hours of community service–typically teaching in needy, low-income schools–and provides for participants to receive $4,725 grants from CNS that can be applied toward their education-related expenses. CNS selects nonprofit organizations that run service programs to train the participants and provide them opportunities to serve. For instance, the University of Notre Dame, a co-defendant in the case with CNS, trains AmeriCorps participants and places them as teachers in needy Catholic schools. CNS pays each of its nonprofit sponsors $400 to defray their administrative expenses. Under federal law governing the program, CNS funds may not be used to provide religious instruction, worship, or proselytization, and sponsors may not discriminate on the basis of religion in selecting program participants. Program sponsors include both religious and non-religious organizations.

As reported in the August 2004 **Nonprofit *Alert*®**, a federal district court struck down the AmeriCorps program on the grounds that it unconstitutionally advanced religion. In particular, the court found that CNS program grants were used for religious purposes by religious institutions who sponsored participants, and by participants who taught religious as well as secular courses at such institutions. CNS and Notre Dame appealed the decision to the federal appeals court of the District of Columbia.

The D.C. appeals court reversed, holding that because the AmeriCorps program was neutral toward religion, any benefit to religion from the program was incidental and constitutionally inconsequential. The court noted that the law governing the program requires that participants and sponsors be chosen without regard to religion. It also noted that after three sponsor organizations violated this rule, requiring participants to meet religious faith criteria, CNS took corrective action and the sponsors withdrew their religious qualification requirements. In response to the lower court's opposition to participants teaching religious classes, the appeals court noted that participants can only receive credit toward their 1700-hour requirement for time spent teaching secular–not religious–subjects. Individual participants who elect to teach religious subjects, in addition to secular subjects, do so on their own time, as a result of their independent, private choices. If a participant does elect to teach religious subjects, he or she is prohibited from wearing the AmeriCorps logo when doing so.

The appeals court also held that the $400 AmeriCorps grants to sponsors to defray training and administrative costs were made on a neutral basis, without regard to the religious nature of the organization. Therefore, such grants did not unconstitutionally advance religion. The court determined that because these grants are de minimis, covering just a small fraction of sponsors' costs, CNS could not reasonably be expected to audit the use of such funds to ensure that they are not used to advance religion. *American Jewish Congress v. Corporation for National Service, University of Notre Dame*, No. 04-5317 (D.C. Cir. March 8, 2005).

## *Nonprofit's Pooling of International Affiliates' Funds Doesn't Require SEC Registration*

The Securities and Exchange Commission ("SEC") has given the green light for a U.S. nonprofit corporation to pool the funds of its international affiliates for investment purposes in the nonprofit's general fund, without having to register with the SEC as a broker-dealer or an investment advisor.

The nonprofit produces and distributes religious literature. It works with foreign nonprofit, non-governmental organizations ("NGOs") that provide similar services outside of the U.S. Some of these NGO affiliates desired to pool their assets, for investment purposes, in the nonprofit's U.S.-based general investment fund. This fund typically produces a greater rate of return than the NGOs could receive in their respective countries. Under the proposed arrangement, the NGOs would receive interest on their investments, and would be able to withdraw some or all of their principal and interest periodically. They would not have any control, however, over how their funds are invested. The nonprofit's investment committee would oversee a group of investment managers who would make fund allocation and investment decisions. The only cost to the NGOs would be reimbursement of their respective, pro rata shares of the nonprofit's administrative expenses in managing the fund. The nonprofit would not receive any transaction-based or performance-based fees.

The nonprofit recently sought and obtained a fact-specific "no enforcement letter" for this arrangement from the SEC's Division of Market Regulation and Division of Investment Management. The letter provides assurance that these Divisions will not require or recommend that the full SEC require the nonprofit to register with the SEC as an investment advisor or a broker-dealer.

The SEC's "no enforcement" position is based, in part, on exemptions from broker-dealer and investment advisor registration laws for 501(c)(3) tax exempt organizations when such organizations provide investment advice only to other charitable organizations. The SEC issued its letter on the conditions that (1) the nonprofit verify that all participating NGOs will be, in their organization and operation, equivalent to 501(c)(3) charities in the United States; and (2) the foreign NGOs that invest in the general fund will not conduct any other business in the United States. The Division of Market Regulation also based its position, in part, on the nonprofit's representation that it

➥ **Foreign NGOs may also be deemed equivalent to U.S.-based 501(c)(3) organizations in other contexts. For instance, a foreign NGO may apply to the IRS for recognition of tax exemption for its U.S.-source income. A foreign NGO may also qualify to be *supported* by a *supporting* organization under Section 509(a)(3) of the Internal Revenue Code. Even if recognized by the IRS as tax exempt, however, foreign NGOs typically cannot receive tax deductible contributions from U.S. donors, unless tax treaties allow such deductibility. Before engaging in a transaction with a foreign individual or entity, a nonprofit should perform a careful legal and risk management analysis of the transaction. Such transactions may be governed by the rules of multiple federal agencies, including the IRS, SEC, agencies that have made grants to the nonprofit, and now the Department of Homeland Security. For a general overview of laws and prudent risk management principles relating to transactions with foreign NGOs, see Gammon & Grange's *Nonprofit Alert*® Memo, *International Nonprofit Organizations*. See last page to order. Also, before managing the investments of any third party, foreign or domestic, and before issuing any bonds or securities to investors, a nonprofit should check with legal counsel regarding application of federal and state securities laws.**

## *"Old" Form 1023 Phasing Out*

Just a reminder: your last day to file the "old" IRS application for tax exemption is April 30, 2005. As reported in the December 2004 / January 2005 **Nonprofit *Alert*®**, the IRS has revised and expanded its Form 1023, *Application for Recognition of Exemption,* to include additional questions regarding compensation, transactions between the applicant organization and insiders, and other potential conflicts of interest and excess benefits. The IRS will accept submissions of both the newly-revised and the old Forms 1023 through April 30, 2005. For submissions postmarked May 1, 2005 or after, the IRS will only accept the new Form 1023. For more information, see www.irs.gov/charities/charitable/article/0,,id=130145,00.html.

**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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