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Nonprofit *Alert*®

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

Inside This Issue of NPA

Supreme Court Denies Certiorari, Signaling...

Positive Outlook for Exempt Bonds

The Supreme Court has denied certiorari in a tax exempt bond financing case, leaving intact a Sixth Circuit decision approving the issuance of municipal bonds to finance a facilities improvement project at a private, religious university in Tennessee. The Sixth Circuit had ruled that issuance of the bonds to benefit the religious university did not constitute excessive entanglement with religion under the First Amendment.

. . . an encouraging decision for faith-based organizations that receive or hope to receive government aid . . .

Indirect Benefit

The bonds "confer at best only an indirect benefit to the school," the court said, and represent part of "a neutral program to benefit education." The Supreme Court's action culminates a legal dispute that began in the mid-1990s when taxpayers challenged the constitutionality of tax-exempt bonds issued by Nashville's Industrial Development Board to David Lipscomb University, a college affiliated with the Church of Christ. The bonds were intended to help finance an estimated $15-million loan for improvement of the college's libraries, athletic facilities, and business center.

Pervasively Sectarian

A federal district court had ruled the bonds violated the Establishment Clause because Lipscomb University is "pervasively sectarian," meaning that religion so permeated the university's educational program that its religious and secular educational functions were inseparable, and that any government funding of the university would unconstitutionally advance religion. But the Sixth Circuit held that the Industrial Development Board only provided neutral "pass-through or conduit financing services" to a wide variety of nonreligious and religious nonprofit organizations in the same geographical area where the college operated.

No evidence suggested the Board ever favored or disfavored religious groups. *Steele v. Ind. Dev. Bd. of Nashville*, Nos. 00-6646/6647/6648/6649 (6th Cir. 2002).

Impact of Decision

This decision is an encouraging development for religious schools and other faith-based organizations that receive or hope to receive government aid. Many legal commentators and some courts have challenged the constitutionality of the "pervasively sectarian" test used by the district court to disqualify David Lipscomb University from receiving government aid on the basis of its "pervasively" religious character.

The U.S. Supreme Court, which has not used the "pervasively sectarian" test since 1988, has more recently applied the "neutrality test" (used by the Sixth Circuit in this case) to uphold government aid to faith-based organizations where such aid is part of a neutral, generally available government program that funds recipients without regard to religion.

For more information on government funding of faith-based organizations, order Nonprofit *Alert*® Memos, *Charitable Choice & Faith-Based Initiatives,* and *Religious Colleges' Participation in Tax-Exempt Financing Programs.* See back page to order both memos.

Tax Exempt Issues

IRS Clarifies Limits on Foundation Transfers to Charity; Relaxes 5-Year Rule for Public Charities

Back in the boom days of the 1990s, many wealthy donors created private foundations to handle their charitable giving. Now during the current economic downturn, those donors are finding their foundations less attractive because of the burdensome paperwork and administrative hassles involved in maintaining private foundations. One alternative donors have discovered is to transfer private foundation assets to a public charity. Until recently, however, this was easier said than done because the IRS generally required public charities to be in existence for at least five years before private foundations could transfer assets to the charities in whole; otherwise, a termination tax would be imposed on the transfer. A new revenue ruling released this spring clarifies that a foundation may transfer assets to a public charity, even if the charity lacks a five-year history. The ruling also says the charity may be a supporting organization (i.e. §509(a)(3) organization). IRS Rev. Rul. 2003-13.

This is good news for donor-advised funds, many of which have been in existence for less than five years. The ruling clarifies that they can now receive contributions of private foundation assets without creating adverse tax consequences for the contributing foundation.

As a practical example of how this might benefit donors, consider a typical family foundation, founded and operated by one or more relatives. Instead of maintaining the foundation, the family might elect to dissolve the foundation and transfer all its assets to a charitable donor-advised fund, from which the family could exercise some direction over fund disbursements without incurring the expense of operating its own family foundation.

Fund Finally Achieves Tax Exempt Status After 10-Year Battle with IRS over Control Issues

The IRS has finally recognized the tax exempt status of the Fund for Anonymous Gifts after a decade of legal wrangling in and out of court. The Fund was established in 1996 to permit individuals to make charitable contributions anonymously. The IRS denied tax exempt status to the Fund, finding that it was only a passive conduit for donations and exercised no independent discretion or control in choosing whether to pass along donor-directed contributions. Rather, the IRS found that donors continued to exercise control over their contributions to the Fund, in violation of tax law. The fund has since amended its organizing documents to limit donor control, requiring that the Fund verify the tax exempt status of donor-designated recipients before contributing designated funds to such recipients. The Fund reached an agreement with the IRS earlier this year that led to the IRS's exemption ruling. The IRS granted the Fund preliminary exempt status as a §501(c)(3) publicly supported organization through an advance ruling period scheduled to end in 2007. At that time, the Fund will need to provide the IRS with evidence that it is supported by a broad enough mix of donors to qualify as a public charity. If it fails to do so, the IRS would reclassify it as a private foundation. A federal district court determined in 2001 that the Fund was a private foundation, which led to the Fund's recent negotiations with the IRS.

... expect more funds to begin marketing anonymity for donors.

Legal scholars have closely watched this case as a proving ground for this unique anonymous giving vehicle. With this positive ruling, expect to see similar funds marketing anonymity to donors. The general principle that all such funds must follow, however, is that they absolutely must exercise complete discretion and control over all donor-designated contributions, as opposed to serving merely as a conduit for funds to pass from one hand to another.

Foundation Giving Slows

Charitable giving by private foundations in the United States increased by only 11.6% in 2001, compared to a 30% increase in 2000, the Foundation Center reports. The onset of recession in early 2001, exacerbated by the terrorist attacks of September 11, caused the slower growth, the Center says. Even more telling is the fact that over half of the 2001 contributions by private foundations came from only a few foundations: Lilly Endowment, Hewlett Foundation, Robert Wood Johnson Foundation, and David & Lucile Packard Foundation.

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Employees & Volunteers

Religious Exemption Applies Throughout Employment, Not Just at Hiring Time

The Title VII exemption that gives religious organizations the right to hire employees of certain faiths applies to all employment decisions, not just decisions made during the hiring process, according to a federal district court in Washington, D.C. The court's decision addressed a Native American employee who worked as a secretary for a global ministries division of the United Methodist Church. She was not a Methodist and made that fact clear to her supervisors from the start of her employment. Throughout her time with the organization, she complained to her immediate supervisor about unwritten job expectations to participate in Methodist worship or devotional services. She also complained that many of the tasks assigned to her required extensive knowledge of the Bible or use of multimedia resources dedicated to Methodist doctrine. She claimed that these tasks conflicted with her own race, religion, and national origin. When her immediate supervisor took no action in response to her complaints, she complained to upper management and was subsequently terminated for insubordination. She brought suit against the church for religious discrimination, but the court ruled her claims were barred by the exemption for religious organizations in Title VII of the 1964 Civil Rights Act, which allows religious organizations to make employment decisions on the basis of religion. She argued that exemption applies only to hiring decisions and in her case, the alleged discrimination didn't begin until after she was hired. But the court ruled that the exemption applies to all forms of employment decisions. The court noted that other federal appeals courts have applied the Title VII religious exemption to employment terminations. Given its application in hiring and firing, the court said it clearly was intended to apply throughout the employment process. *Hopkins v. Women's Div., General Bd. of Global Ministries*, 2002 WL 31886673 (D.D.C. 2002).

Understand the full scope of the Title VII religious organization exemption, and the ways in which courts have applied that exemption, by ordering Nonprofit Alert Memo, *Hiring & Firing: Rights of Religious Employers.*

IRS Hooks Company Fishing Trip Fringe Benefits

An Iowa company is on the hook for $57,000 in payroll taxes after a federal district court decided the value of the company's annual fishing trips was actually a taxable fringe benefit to employees. The company arranged yearly sales meetings that lasted two days, followed by an all expense-paid fishing trip at a distant resort. Employees spent one day traveling to the resort and two days fishing, then returned home on the weekend. Employees received their regular pay during the week, but the trips were not mandatory. At least one business meeting was always scheduled at the resort, and other informal business discussions took place during the trips. However, no records of meetings or business discussions were kept. The company also took steps to assign certain business partners to specific cabins and boats to facilitate further informal work-related exchanges. Despite these measures, the IRS interpreted the value of the trips as additional compensation to employees. At trial, the company was unable to demonstrate that the trips were continuations of its sales meetings or in any way

(continued on next page)

NPA Highlight of the Month

Responding to Crisis: Recommendations for Charities

Following the criticism that some charities received in response to their post September 11 relief efforts, a number of studies were conducted to identify ways for charities to better respond in such emergencies. Two such studies were recently released by the Century Foundation and LBG Associates. Their findings shed light on how charities could have responded more effectively in the aftermath of September 11. Among the studies recommendations are:

- Adopt clear guidelines for receiving and distributing funds for emergency relief. Establish the financial and administrative networks necessary to quickly implement those guidelines.
- Build partnerships with relief organizations to which your charity could easily contribute resources, personnel, or otherwise help meet needs during a disaster. This could be as simple as naming your organization as a drop-off for community donations, or as complex as training personnel for emergency response.
- Appoint a single spokesperson to handle all media contacts so your charity gives a consistent message, but don't rely solely on the media to get that message out during a crisis. Communicate directly with donors, volunteers, and the public through direct mail/email or even paid advertisements, if necessary.

Nonprofit Alert Memo, *Media Relations: Making the Media Work for You*, offers practical tips for handling crisis communications. See back page to order.

(continued from p. 3) directly related to its business. Therefore, the court ruled the trips were primarily entertainment, and any business conducted on the trips was merely secondary. As such, the value of the trips was fully taxable to employees, the Court ruled. *Towsnsend Industries, Inc. v. U.S.*, No. 4-10-CV-10176 (IO. C.D. 2002).

The key here: *business relatedness*. If your organization sponsors business or mission-related retreats or trips for employees, be sure to structure the events in such a way that the primary purpose of the event demonstrably furthers your charitable mission. This connection should be readily apparent through contemporaneous documentation of the business-related activities conducted at the event(s). Employee entertainment and recreation must clearly be secondary.

Liability & Risk Management

Founder's Advisory Contract Avoids Self-Dealing

A family foundation did not violate the tax code prohibitions against self-dealing when it compensated its founder for investment services that he provided to the foundation, the IRS has ruled. The founder was the sole contributor to the foundation. He operated a professional investment advisory firm in which he was also the sole proprietor, providing investment strategies, research, and management services for clients. The foundation contracted with the founder for his investment services, but specified that his compensation would be determined on a quarterly basis through a complex process of evaluating and averaging other independent firms' costs and fees for the same services. This contractual process helped convince the IRS that the founder's compensation was fair and reasonable. The arrangement met the personal services exception of Internal Revenue Code §4941, the IRS ruled, and therefore did not trigger any self-dealing penalties.

At Press Time: Senate Passes CARE Act With Incentives for Charitable Giving

The Senate passed legislation last month establishing new tax breaks for charitable giving, including a long-sought amendment to the tax code that allows limited charitable deductions for non-itemizers. The bill, known as the CARE Act, permits people who don't itemize on their tax returns to deduct up to $500 for any charitable contributions they make over $250 in any single year (or up to a $1,000 deduction for contributions over $500 on a joint return). It also permits tax-free distributions from an individual retirement account if made directly to a qualified charity. The legislation was pared down from the President's original "faith-based initiative" legislation that would have protected the ability of religious organizations to compete on an equal basis with secular charities for government aid for social service programs. The faith-related parts of the bill underwent so much scrutiny from opposing groups and Senators that they were eventually deleted from the bill.

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