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Nonprofit *Alert*®

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

Inside This Issue:

IRS Cracks Down on Fraudulent Tax Shelters; Issues Warning to Nonprofits

The IRS has warned charities to withdraw their participation in certain arrangements involving corporate stock donations to charities because the arrangements are fraudulent tax shelters. The Senate Finance Committee also announced it will investigate any charities that have engaged in such arrangements.

The arrangement involves a complex gift transaction of corporate stock to charities. The charities then sell the stock back to the corporations at a later date. These sales enable corporations to avoid certain income taxes and individual donors to take hefty tax deductions, according to a recent notice issued by the IRS. It is not known exactly how many charities may have participated in the banned tax-shelters.

> The IRS considers nonprofits to have participated in these schemes, beginning with the time they received donations of stock, until the stock was sold.

The IRS notice says exempt organizations will be treated as having participated in these schemes during the years they received the donations, plus all intervening years before the corporate stock was resold. Parties involved in these transactions, or substantially similar transactions, may be subject to penalties imposed by the IRS under several sections of the tax code, including the accuracy-related penalty of §6662. IRS Notice 2004-30.

In a related matter, the Department of Justice ("DOJ") also announced a crackdown on other allegedly illegal tax shelters, including asset transfers to a "corporation sole," a corporate form used by some churches. DOJ filed suit last month in eight states against six promoters of these shelters who allegedly sold them to 700 customers in the United States and overseas.

The promoters allegedly advised customers to transfer assets into a corporation sole. Customers would then declare themselves as the leaders of fabricated religious organizations, enabling the "corporation sole" to pay their personal living expenses tax free, in violation of tax law. DOJ says the promoters offered the schemes over the Internet for a $200 to $2300 fee.

The "corporation sole" is listed among DOJ's "Dirty Dozen" abusive tax schemes for 2004. Read more at http://www.irs.gov/newsroom/article/0,,id=120803,00.html. The IRS notice is at http://www.irs.gov/pub/irs_utl/n_04_30.pdf.

Liability & Risk Management

Following Investigation, Nature Conservancy Makes Changes to Improve Accountability of Insiders

The Nature Conservancy has announced changes in its board policies that require board members to comply with tighter oversight and accountability measures. The changes come amid ongoing investigations by the IRS and the Senate Finance Committee into alleged private inurement and questionable donor practices at the organization. (See ***NPA*, March ’04**).

The Conservancy’s board has now been divided into committees to help alleviate potential conflicts of interest that individual board members might have with the organization. The Conservancy also announced that it now requires its executive officers and board members to maintain more frequent contact with each other than they maintained in the past when alleged “insider” deals occurred.

> “... there’s a need for broader reforms of charities.” -- Sen. Charles Grassley, Chairman, Senate Finance Committee.

Earlier this spring, the IRS launched an investigation into alleged benefits that Conservancy “insiders” took in below-market value property sales and home loans. A *Washington Post* article reported the organization purchased land for conservation, then sold it to select individuals (including board members and senior staff) at less than fair market value through the Conservancy’s “conservation buyer” program.

The Senate Finance Committee also began an investigation last year into potential tax violations involving excess benefits given to Conservancy trustees and senior staff. (See ***NPA*, Aug.‘03**). That investigation continued last month as Sens. Charles Grassley (R-IO) and Max Baucus (D-MT) sent an 18-page request for the Conservancy’s records on tax-sheltered conservation easements.

In another development, an independent panel of experts completed a review of the Conservancy’s processes last month and recommended broad reforms in the way the organization does business, including greater financial disclosure and stricter controls on financial transactions. Sen. Grassley, who chairs the Senate Finance Committee, says “there’s a need for broader reforms of charities,” and suggests that other nonprofits should adopt the report’s recommendations.

Would the recommendations work if applied to your organization? Read the full report at http://nature.org/pressroom/files/gap_final.pdf.

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Jury Secures Nonprofit Hospital's Tax Exemption

A jury in Austin, Tex. has ruled that the nonprofit St. David's hospital may retain its exempt status even though it maintains a partnership with a for-profit hospital company. The case was remanded to the U.S. District Court for the Western District of Texas after the Fifth Circuit vacated a lower court's ruling in January that favored St. David's. The Fifth Circuit instructed the district court to determine whether St. David's maintained appropriate control over its day-to-day operations during its joint venture with the for-profit hospital company. (See **NPA, Jan. '04**).

The Fifth Circuit was troubled by several issues, including a non-compete clause in the partnership agreement, which the court believed undercut St. David's power. The court also noted St. David's, through its representation on the partnership's board, had power only to veto certain decisions but not to control a majority of the board or to dissolve the partnership. The court suggested that a nonprofit's governance of and operational control in a joint venture must be more extensive, but remanded the case back to the District Court for further fact finding on these issues.

The District Court jury determined that St. David's can remain tax exempt because enough safeguards exist in the partnership agreement to protect the hospital's charitable mission, despite its involvement with the for-profit partner. The IRS is considering whether to appeal the ruling. An IRS spokesperson said the guidance provided in the Fifth Circuit's original ruling in January is still valid, regardless of this latest jury decision, and should be relied upon by nonprofits in structuring joint ventures with for-profit entities. *St. David's Health Care System v. United States of America*, No. 101CV-046 (W.D.TX, 3/4/04).

Executive Order Urges National Service Programs to Expand Work With Religious Groups

President Bush issued an executive order last month urging AmeriCorps and other national service groups to expand and strengthen its working relationships with religious organizations. The order requires AmeriCorps to "...expand opportunities for, and strengthen the capacity of, faith-based and other community organizations in building and strengthening an infrastructure to support volunteers that meet community needs."

The order also directs national service groups to adopt performance measures that ensure accountability and enable identification of programs that are worthy of further investment. An additional measure in the order directs *(continued on page 4)*

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Nonprofit & Tax Exempt Issues

For more information on developing and managing a volunteer program, see **Nonprofit Alert® Memo,** ***Managing Volunteers: Risks & Rewards.***

Charities Lagging in Volunteer Recruitment

Despite a renewed focus on volunteer management in the nonprofit community, recruitment still presents the biggest hurdle for most charities, a new survey reveals. More than half the charities surveyed employ a staffer who manages their volunteer programs, but an overwhelming majority of the charities said they needed more volunteers. On average, charities said they could easily use an additional 20 volunteers in their current programs.

The study compiled responses from 1,753 charities and 544 religious organizations nationwide. In particular, charities report:

- difficulty in finding volunteers to work during weekdays;
- inability to provide adequate training for volunteers;
- lack of funding to support volunteer programs; and
- challenges in recruiting enough volunteers.

The good news is that staffers who supervise volunteer programs appear to be better trained now than ever before. 66% reported having received some degree of formal training, either through course work, conferences, or workshops. At religious organizations, 72% of volunteers surveyed reported they received formal volunteer training from those organizations.

The survey was co-sponsored by the UPS Foundation, Corporation for National Service, and USA Freedom Corps. Copies of the report, “Volunteer Management Capacity in America’s Charities and Congregations,” are available at http://www.nationalservice.org/.

Executive Order . . . . *(continued from page 3)*

certain management reforms, including institutionalized changes to budgetary and grant-making processes and improved compliance with fiscal restrictions.

Presidential executive orders carry the weight of law but do not have the approval of Congress. President Bush previously issued an executive order in 2002 relaxing the rules on religious charities that receive federal funding.

Read the full text of the executive order at http://www.whitehouse.gov/news/releases/2004/02/20040227-9.html.

New Law Makes Employee Investigations Easier

The Fair and Accurate Credit Transactions Act (FACT Act), which took effect earlier this year, relaxed some of the privacy protections of the Fair Credit Reporting Act (FCRA) that previously hampered employers' ability to investigate employee misconduct. The FACT Act now permits employers to conduct a third-party investigation into an employee's financial affairs without first securing the employee's written permission.

Employers may only launch such an investigation if an employee's misconduct is related to his or her employment or to a violation of law, but not if the employer merely wants to review the employee's creditworthiness, credit capacity, or standing. The employer must provide a summary report of the investigation to the employee if the employer takes any adverse action as a result of the investigation's findings. However, the report doesn't have to disclose the sources used in the investigation, nor does the employer have to provide the report until after the adverse action is taken.

Previously, under FCRA, employers were required to obtain an employee's written consent before a credit investigation could commence. If the investigation produced information that led to an adverse employment action, then the employer was required to provide notice to the employee *before* the action took place, along with full disclosure of all documents produced during the investigation (which typically revealed all sources in the investigation).

While the majority of the FACT Act addresses fair lending practices and other issues that have little impact on most nonprofits, this little-known employee finance investigation provision represents a favorable policy change for all employers, including nonprofits. Read the text of the **new law** for more information. Scroll to Title VI of the law for the provision on employee investigations.

Editor's Farewell

After 10 years as Editor of the Nonprofit Alert®, I depart this month to pursue a new endeavor in publishing. The NPA will continue under the guidance of Chip Grange as Editor-in-Chief and Steve Clarke as the new Editor. I bid a fond farewell to my readers and colleagues, who have together provided much of the inspiration and encouragement that kept the Nonprofit Alert® on target each month. Your work represents the best of the human spirit. Thank you for your unwavering commitment to charitable service. May your continued efforts be blessed.

– Sarah J. Schmidt

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