



Nonprofit *Alert*®

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

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IRS Commences Crackdown on Excessive Compensation

The Internal Revenue Service recently announced that it has launched an aggressive and comprehensive enforcement initiative in which it will contact nearly 2,000 tax exempt organizations and request information on their compensation practices and procedures. Organizations on the target list will include those whose Form 990 returns have raised red flags, especially those that pay their executives high compensation, provide loans and other questionable benefits to their leaders, and/or engage in insider deals (e.g., a nonprofit that hires a company owned by one of its directors). The IRS also plans to contact randomly selected nonprofits for questioning.

The IRS likely will ask targeted organizations about how they set and report compensation for specific executives; the roles, selection process, and duties of their board members; and their conflicts of interest, recordkeeping, and checks and balances policies, according to Steven T. Miller, commissioner of the IRS's tax-exempt and government entities division. Mr. Miller said the IRS likely will not examine those nonprofits that it determines, based on their Forms 990, have adopted practices and policies that promote good governance, ethics, and internal oversight. Some such organizations may be required to verify that the information reported on their Forms 990 is accurate.

The IRS states that its purpose in launching this project is to increase compliance with IRS compensation rules by (1) addressing excessive compensation of specific individuals and questionable compensation practices of specific organizations; (2) increasing organizations' awareness of tax regulations as they set compensation of officers and managers in the future; and (3) learning more about how organizations set and report compensation on their Forms 990. To gear up for these audits, the IRS is increasing its revenue agent audit staff by more than 20%. The IRS will continue this project through 2005.

➔ Under current tax law, a charity can only pay "reasonable compensation" to its leaders. Reasonable compensation is measured with reference to the amount that would ordinarily be paid for comparable services by comparable entities under comparable circumstances. Further, none of the assets of a tax exempt organization can "inure" to the benefit of an individual (i.e., the individual cannot receive in excess of fair market value in return for the goods or services he or she provides to the organization). Such private inurement / excess benefit violations can result in the organization losing its tax exempt status, and/or in "Intermediate Sanctions" (i.e., penalty excise taxes). The IRS recently imposed Intermediate Sanctions against a charity's founder and the founder's spouse, two sons, and son-in-law for deriving excess benefit from personal use of the organization's real property, credit cards, cell phone, and vehicles. See TAM 200435018; TAM 200435019; TAM 200435020; TAM 200435021; TAM 200435022 (all released August 27, 2004). For more information on Intermediate Sanctions and how to avoid them, order *Nonprofit Alert® Memo, Avoiding the Snares of Intermediate Sanctions*. For general principles on how to prepare for an IRS examination, see *Nonprofit Alert® Memo, Preparing the Nonprofit for an IRS Visit*. See last page to order.

Senate Finance Committee Seeks Input on Proposed Nonprofit Reform Legislation

In the August / September 2004 issue of the *Nonprofit Alert*®, we reported that Senate Finance Committee Chair Charles Grassley (R-Iowa) planned to propose sweeping nonprofit reform legislation this fall. In June and July, the Committee held two roundtable discussions on a Discussion Draft of proposed new oversight measures that, if enacted as legislation, would impose a five-year exempt status review by the IRS, expand Form 990 reporting requirements, impose stricter requirements related to conflicts of interest transactions, restrict the operations of donor advised funds, and impose other limitations on nonprofits.

“The closer we look at charities in our Finance Committee investigation, the stronger the case gets for meaningful legislative reforms that shut down exorbitant pay for charity executives and sweetheart deals for insiders.” Senator Charles Grassley (D-Iowa).

At the time of publication, no such charitable reform legislation has been introduced. However, Sen. Grassley and Max Baucus (D-MT) have asked Independent Sector (“IS”), a D.C.-based coalition of approximately 600 nonprofits, to convene a panel of experts to recommend legislative action to curb abuses at nonprofits. They also asked IS to recommend ways to strengthen governance, ethical conduct, and effective practices among nonprofits. The initial IS report is due by February 2005. IS plans to establish several advisory groups to consider the issues posed by the Committee.

➔ **For more information about the reforms the Senate Finance Committee has proposed, see its Discussion Draft at <http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf>, or visit the Independent Sector website at <http://www.independentsector.org/>.**

New Overtime Pay Provisions Take Effect, For Now

Despite congressional opposition, the Department of Labor’s new overtime pay rules took effect on August 23, 2004. As reported in the June 2004 *Nonprofit Alert*®, these rules raised the annual salary threshold requirement for minimum wage and overtime pay from \$8,060 to \$23,660 (\$455 a week). Now, employees earning less than \$23,660 cannot be exempt from minimum wage and overtime pay. Employees earning more than that amount (but less than \$100,000, with some exceptions) are entitled to time-and-a-half overtime pay unless they fall into one of the exempt categories. The new overtime pay rules retain the executive, administrative, and professional exempt categories, but change some of the criteria employees must meet to be classified as an executive, administrative, or professional employee. The DOL estimated that the new rules would extend overtime and minimum wage rights to 1.3 million workers who were denied these rights under the obsolete \$8,060 threshold.

Critics of the new rules allege that, because of changes in the definitions of administrative, executive, and professional employees, millions of employees who were non-exempt (and entitled to overtime pay) are now exempt from overtime pay requirements under the new rules. For instance, the Economic Policy Institute estimated that 2 million low-level supervisors are now exempt under the new rules’ redefinition of “executive employees” to include employees who can recommend—but not carry out—the “change of status” of two employees that they supervise. The Institute estimated that approximately 6 million employees would lose their overtime rights as a result of the new rules.

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One of these critics, Senator Tom Harkin (D-IA), introduced an amendment to the 2004 JOBS Act (S1637) that would strike down the DOL amendments to the exempt category criteria, while retaining the increased \$23,660 salary threshold. This amendment was approved by the Senate Appropriations Committee on September 14. A similar measure introduced in the House 2004 JOBS Act (HR4520) was also approved on September 14. On October 6, however, a joint Senate-House Conference Committee struck the amendment from this Act. Consequently, the new overtime rules remain effective for the time being. According to an aide of Senator Harkin, he plans to attach the same amendment to future legislation.

➔ **For more information on the application of the new overtime rules and exemptions to your organization's employees, contact Stephen Clarke at (703) 761-5000 or smc@gg-law.com.**

2004 Election "Dos" and "Don'ts" Checklist for 501(c)(3) Organizations

With the November election right around the corner, it is important for 501(c)(3) organizations to mind their "Ps" and "Qs" with regard to any political-related activity they engage in so as not to jeopardize their tax-exempt status. Though 501(c)(3) organizations are strictly forbidden to support or oppose any candidate for public office, any political party, or any political action committee (whether in oral, written, or electronic form), there are some activities that 501(c)(3) organizations can engage in, such as nonpartisan voter education and voter registration drives. Below is a list of "dos" and "don'ts" for your nonprofit organization in this election season:

"Dos" - permissible activities for a 501(c)(3) organization (so long as such activities are conducted in an entirely nonpartisan manner):

- Educate the public on specific issues or pending legislation.
- Conduct nonpartisan voter registration drives and place a link to a nonpartisan voter registration site on your website.
- Publish an article on your organization's website or in its newsletter about the importance of voting, and/or encourage participation in the political process.
- Provide accurate, unbiased information on the positions of the candidates on a wide range of issues.
- Host or sponsor a nonpartisan candidate forum, inviting all candidates for a particular office to participate.
- Encourage staff, officers and board members to vote, and provide staff with time off to vote.
- Allow your staff time off work to serve as poll workers.
- Host a seminar for nonprofit, tax exempt organizations on the IRS political activity rules for 501(c)(3) organizations.
- Remind the organization's members, directors, officers, employees, and volunteers that if they participate in any political campaign activity, they must do so solely in their personal capacities. Indicate to third parties, if potential for confusion exists, that any such activity is in a personal capacity and not on behalf of the organization.

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Election “Dos” and “Don’ts”.....[continued from page 3]

“Don’ts” - impermissible political activities for a 501(c)(3) organization:

- Endorse or show favoritism for one candidate, political party, or political action committee.
- Make campaign contributions (financial or in-kind) to a political candidate or political party.
- Support voter registration drives conducted by one political party.
- Participate in political fundraising endeavors for a political candidate or political party.
- Contribute time, facilities, or other resources to a candidate, political party, or political action committee.
- Publish or communicate anything that explicitly or implicitly favors or opposes a candidate for public office or a political party.
- Allow a director, officer, member, employee, or volunteer of the organization to participate in any political activity using organization time, money, and/or other resources.

➔ For an overview of the legal restrictions on nonprofits’ participation in political activity, see **Nonprofit Alert® Memo, Nonprofit Lobbying and Political Activity—Know Your Limits**. To see the IRS election year advisory, click on <http://www.irs.gov/newsroom/article/0,,id=122887,00.html>. These materials provide general guidance only and should not be relied upon as legal advice. Please consult Stephen King at shk@gg-law.com or (703) 761-5000 with specific questions and guidance regarding IRS political activity rules.

Democratic and Republican Party Platforms Address Nonprofit Concerns

On the eve of the Presidential election, you may be wondering how the election of George W. Bush or John Kerry might effect charities, their donors, and their beneficiaries. The following are excerpts from the Republican and Democratic platforms (both available at <http://www.issues2000.org/>) addressing government cooperation with faith-based social service providers and other issues of relevance to nonprofits:

2004 Democratic National Platform:

- “We will strengthen the role of faith-based organizations in meeting challenges like homelessness, youth violence, and other social programs. At the same time, we will honor First Amendment protections and not allow public funds to be used to proselytize or discriminate.”
- “. . . continuing on the path of welfare reform . . . We must match parents’ responsibility to work with the real opportunity to do so, by making sure parents get the health care, child care, and transportation they need. And we must expect increased responsibility from fathers as well as mothers by increasing child support enforcement and promoting responsible fatherhood together with religious and civil organizations.”
- “Instead of pushing private school vouchers that funnel scarce dollars away from the public schools, we will support public school choice, including charter school and magnet schools that meet the same high standards as other schools.”

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Party Platforms Address Nonprofit Concerns.....[continued from page 4]

- "We should support character education in our elementary and secondary schools and community service as a condition of graduation from high schools."
- "We will offer generous tax credits to reduce the price of four years of college for all students, including those who pay their own way and can least afford college now."
- "We will of course reverse this Administration's cuts in wages for working people by restoring overtime protections for hard-working Americans . . . [we will raise] the minimum wage to \$7.00."

2004 Republican Party Platform:

- "We urge the Congress to act on legislative proposals to enhance private-sector works of charity and compassion. We also affirm that hiring rights of religious organizations must be maintained so that religious charities do not have to abandon their religious character in order to provide publicly funded services."
- "We support the President's efforts to encourage volunteer service and civil involvement to strengthen our communities and our nation, and to help people in need [through] . . . the USA Freedom Corps . . . the new Citizens Corps . . . and Peace Corps."
- "The President has proposed a four-year, \$300 million initiative to reduce recidivism and help released inmates contribute to their communities. The initiative will harness the resources and experience of faith-based and community organizations in providing job training and placement services to 50,000 non-violent adult ex-offenders, transitional housing for up to 30,000, and voluntary mentoring support."
- "The Republican Party strongly supports school choice . . . We believe that competition between schools is an effective option to improve the educational benefits for our children. The Republican Party supports the efforts of parents who choose faith-based and other nonpublic school options for their children."
- "Under a new Pell Grant proposal, low-income students who take a rigorous high school curriculum . . . will be eligible to receive an additional \$1,000 per year. . . . Needy students studying math and science will be eligible to receive additional college aid."
- "1.3 million additional workers now have guaranteed overtime protections as a result of Republican efforts to modernize labor laws. For the first time ever, the regulations explicitly guarantee overtime protection to blue collar workers, police, firefighters, EMTs, factory workers, construction workers, and licensed practical nurses, among others."

Anti-Terrorism Legislation and Government Policies Affecting Nonprofits

The Senate Finance Committee recently announced that it plans to hold within the next several weeks a hearing on financing of terrorism by charitable organizations. Earlier this year, the Finance Committee asked the IRS to turn over confidential records, including names of contributors, related to 24 charitable organizations suspected of having links to terrorist activities.

Since 9/11, new federal laws, regulations, executive orders, and governmental policies have been enacted or issued to prevent or reduce the likelihood of terrorist financing by nonprofit tax exempt organizations. Some of these laws give the government broad powers to impose sanctions on nonprofit organizations that it believes support terrorist activity. Nonprofit boards should be vigilant and proactive in adopting and implementing strategies and policies to prevent their organizations from inadvertently funding—directly or indirectly—a terrorist group or activity. To that end, the following is a summary of relevant laws, policies, and guidelines nonprofit Board members should be aware of:

Military Family Tax Relief Act. This law has given the IRS the authority to suspend the tax-exempt status of any organization that is designated by a government authority as a terrorist organization or a supporter of terrorism.

Patriot Act. The USA Patriot Act prohibits providing material support or resources knowing or intending that they be used in performing or carrying out a terrorist act, and providing or collecting funds for use in terrorism. The Act gives the President emergency powers for dealing with threats to the United States, including blocking the assets of suspected terrorists or supporters of terrorism—including assets of nonprofit organizations.

USAID. To receive USAID funding, a non-governmental organization must certify it has taken all reasonable steps to ensure it does not and will not knowingly provide material support or resources to any individual or entity that commits, attempts to commit, advocates, facilitates, or participates in terrorist acts, or has committed, attempted to commit, facilitated, or participated in terrorist acts.

Combined Federal Campaign. Any charitable organization wishing to participate in the CFC must now certify in its application that it “does not knowingly employ individuals or contribute funds to organizations found on [certain] terrorist related lists promulgated by the U.S. Government, the United Nations, or the European Union.”

Treasury Guidelines for Anti-Terrorist Practices by Charities. These voluntary guidelines include some elementary principles of Board governance for charities (*e.g.*, operate in accordance with their articles and bylaws, have regular board meetings, publicly disclose board members and officers and their compensation, if any, adhere to a budgetary approval and review process, submit to annual audits, record receipts and disbursements). They also include “Anti-Terrorist Financing Procedures” for evaluating potential organizations to which the charity may be making grants or providing financial support, such as the following:

- Request detailed information on the potential fund recipient’s identity (*e.g.*, alternate names), related organizations (*e.g.*, affiliates, subsidiaries), and activities; and
- Request substantiation of the potential fund recipient’s budgetary and accounting practices.

Financial Action Task Force on Money Laundering Guidelines. FATI, an inter-governmental body whose purpose is the development and promotion of policies to combat money laundering and terrorist financing, recommends the following measures:

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Anti-Terrorism Legislation.....[continued from page 6]

- Require that potential recipients of the organization's funds have prepared full program budgets for all program expenses, the identity of other recipients / subgrantees to whom the funds may be given, and the intended use of the money;
- Confirm that such recipients actually received funds that the organization sent to them;
- Maintain registered bank accounts and use formal financial systems to conduct financial transactions;
- Ensure that all funds and assets that the organization gives to recipients are accounted for and used for their intended purposes;
- Undertake proactive verification measures to ensure that those persons and organizations to which an organization provides funding or material support are not being penetrated or manipulated by terrorists; and
- Require an annual independent audit of the organization's corporate books and records.

➔ For more information on the application of anti-terrorist laws to charities, and what your nonprofit can do to comply with these laws, contact Steve Kao at ssk@gg-law.com or (703) 761-5000. Also, the Independent Sector has developed a helpful handbook that summarizes the certain anti-terrorism laws affecting nonprofit organizations, which is available at <http://www.independentsector.org/PDFs/counterterrorism.pdf>

Life Cycle of a Public Charity

The IRS has posted on its web site a new resource designed to help charities understand the process involved in obtaining tax exempt status and complying with applicable tax exempt laws and regulations. "Life Cycle of A Public Charity" provides information, explanations, guides, forms, and publications to help tax exempt organizations understand and comply with their legal obligations. It is available on the IRS web site at <http://www.irs.gov/charities>.

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