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Nonprofit *Alert*®

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

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Congress Giving Mixed Signals on Charitable Reform

A year after a Republican-led Congress passed the most sweeping charitable reform measures in more than a decade in the Pension Protection Act of 2006 (PPA 2006), a Democratic-led Congress is giving mixed signals about whether it will continue efforts to draw public attention to nonprofit "abuses" and to pass legislation that stiffens regulation of charities.

On July 24th, the House Ways and Means Subcommittee on Oversight met to reiterate its support for the charitable sector, but emphasized the need to stop abuses. Among those who testified at the hearing were Diana Aviv of Independent Sector, and Gregory D. Kurtz, the Managing Director of Forensic Audits and Special Investigations at the Government Accountability Office. The GAO released a study that found that as of September 30, 2006, almost 55,000 exempt organizations had close to $1 billion in unpaid federal taxes, with 501(c)(3)s responsible for 85 percent of that amount. Kurtz asserted that the $1 billion figure is an understatement because "some exempt organizations have understated tax liabilities or did not file tax returns." Kurtz added that more than 1,200 entities with unpaid federal taxes had received $14 billion in federal grants.

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Kurtz also testified that the GAO investigated 25 of the organizations with unpaid taxes and found abusive and criminal activity, leading him to conclude that some nonprofit executives were making "careers" out of not paying federal taxes. He also cited trustees using payroll tax money (that should have gone to the IRS) for their own salaries and personal expenses, including multimillion dollar homes and luxury vehicles. Kurtz' focus on abuses was reminiscent of statements heard and made by the Grassley-led Senate Finance Committee in 2005 and 2006, which created momentum for charitable reform.

The same day, the Senate Finance Committee released a June 28th letter to ranking minority member Grassley from IRS Acting Commissioner Kevin Brown that identified the IRS's top compliance concerns regarding tax-exempt organizations. While Brown's letter noted "the excellent work the tax-exempt community does every day" and mentioned that most exempt organizations and governmental entities obey the tax laws, he listed trouble spots, such as exempt organizations accommodating abusive transactions, overvaluation of donated property, abuses involving credit counselling, and excessive compensation.

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Charitable Reform...continued

However, Senator Max Baucus (D-MT), the Democrat who replaced Senator Grassley as Chairman of the Senate Finance Committee, recently declared that he does not plan to give high priority to imposing new regulations on nonprofit groups. In an interview with The Chronicle of Philanthropy, Senator Baucus stated that although he and Senator Grassley "work very closely together," he suggested that his timetable and priorities regarding charitable reform were different from his colleague. Thus, in an apparent role reversal from one year ago, the House Ways and Means seems to be paying greater attention to nonprofit "abuses," while the Senate is momentarily turning its focus elsewhere.

Survey of Nonprofit Board Governance Shows Mixed Results

Despite increased scrutiny on corporate governance in the wake of Sabanes-Oxley, many charities have failed to institute the same reforms as their for-profit counterparts. A recent study by the Urban Institute, a think tank based in Washington D.C., reveals less than stellar board practices, causing some concern. Among its findings, over 20 percent of nonprofit groups make insider deals with board members, while many have not adopted conflicts of interest policies that ensure that these transactions are in the best interests of the organization.

Of the 5,100 nonprofit organizations surveyed by the Urban Institute, 21 percent have bought goods, services, or property from companies affiliated with their board members. Additionally, 71 percent do not require their board members to disclose their financial interests in entities doing businesses with their organizations, and 19 percent of boards that oversee organizations with $100,000 to $500,000 in annual expenses have members who are related to each other.

Such practices are causing some nonprofit experts to question whether there is a problematic level of insularity among nonprofit boards which contradicts their public-service mandate. Such statistics may also add fuel to those state and federal regulators and lawmakers who wish to create new disclosure and compliance measures for charities.

Still, the study does not report all bad news but indicates that many nonprofits have been proactive in addressing governance since the passage of Sarbanes-Oxley. For instance, 47 percent of the organizations studied with conflicts of interest policies reported that they created or revised the policy since 2002. Similarly, 46 percent of organizations with whistleblower policies adopted or revised the policy since the passage of Sarbanes-Oxley, and 54 percent of organizations with separate audit committees established or revised their audit committee policies since 2002. Additional information reported in The Urban Institute study is available at www.urban.org.

⇨ For more information regarding the proper handling of interested party transactions by nonprofit boards, order Gammon & Grange's **Nonprofit Alert® Memo *Conflicts of Interest Policy.***

New Guidance on Prohibited Political Activity

One of the more controversial restrictions on tax exempt 501(c)(3) organizations is the prohibition on political campaign intervention. The tax exemption of a 501(c)(3), including churches, may be revoked if the organization supports or opposes a particular candidate in an election. While accusations of prohibited campaign intervention have become more and more prevalent in recent election cycles, and IRS investigations related to campaign intervention has increased, there has been little precedential guidance as to what activities are prohibited. This paucity has been remedied somewhat with the June release by the IRS of Revenue Ruling 2007-41.

Revenue Ruling 2007-41 (available at www.irs.gov) contains 21 factual scenarios which shed some light on facts and circumstances that may lead the IRS to conclude that an organization has engaged in prohibited campaign intervention. The 21 examples touch on such issues as candidate appearances and forums, personal endorsements by organizational leaders, web links, and permitted voter education and issue advocacy versus prohibited political activity. Although certainly not exhaustive, organizations should find Revenue Ruling 2007-41 helpful in steering clear of prohibited activity.

IRS Vets New Form 990

The IRS recently released a draft of a substantially updated and modified Form 990, the annual return that most exempt organizations are required to file with the IRS. This is the first major overhaul to the Form 990 in 25+ years, and has been called by one IRS official "probably the biggest thing that Exempt Organizations has done in the last quarter century." As well as a new format (a ten page core form, along with 15 schedules designed to require reporting of information only from those organizations that conduct particular activities), the draft form includes various questions on board governance, organizational policies, executive compensation, international activities, use of professional fundraisers, and noncash contributions that are not covered in the current 990. The first page of the new draft is a summary page that the IRS indicates should give the public a better and more accessible snapshot of the organization.

➩The draft revised Form 990 can be viewed at www.irs.gov/charities/index.html. The IRS is taking comments on the new form until September 14. Comments may be submitted by email to Form990Revision@irs.gov. The IRS expects that the new Form 990 will be put into use for the 2008 tax year.

Attempt to Hold Denomination Responsible for Minister's Misconduct Rejected

A Minnesota appeals court recently held that a denominational organization was not liable for the sexual misconduct of a retired minister who occasionally conducted worship at one the denomination's member churches. The minister, ordained in the Evangelical Lutheran Church in America, had pleaded guilty to second-degree criminal sexual assault related to an incident with the child of family friends who frequently stayed in the home of the pastor and his wife. The victim brought a civil suit against the pastor, the local church in which the pastor occasionally conducted worship, and the regional and national denominational offices.

The victim claimed that the denomination should be liable for the minister's action based on the theory of respondeat superior – the legal doctrine that an employer is liable for the acts of an employee done in the scope of employment. The Minnesota court rejected this claim, holding that even though the denomination sets standards by which its ordained ministers must abide and has the authority to discipline ministers, this does not rise to the level of control that characterizes an employer/employee relationship. Although the denominational rules result in limited control over the ministers by the denomination, the employing local churches (which in this case there was none given that the minister was retired) maintain employment control over the ministers by making hiring and firing decisions, setting the terms and conditions of employment, and paying the pastor.

Florida Clarifies Property Tax Treatment for Charity-Owned Single Member LLCs

As previously reported in the NPA, the use by tax exempt organizations of single member limited liability companies (LLCs) is becoming increasingly prevalent. Creating a wholly-owned LLC to house an activity with particular risks may provide liability protection for the parent charity. Moreover, creating the LLC generally has no adverse federal tax consequences given that the IRS, through various notices, has made it clear that single member LLCs are "disregarded entities" for tax purposes. In other words, for federal tax purposes all financial activity of the LLC is reported as the activity of the member charity, and the LLC is not required to separately establish a basis for its tax exemption.

Despite the federal guidance, some questions about tax treatment of single member LLCs have remained on the state and local level in various jurisdictions. For instance, will property owned by a single member LLC be deemed owned by the member charity for property tax purposes? This question was recently answered in Florida when legislation was enacted to clarify that property held by a tax exempt organization's single member LLC will be treated as owned by the tax exempt organization for the purposes of determining whether the property is exempt from property tax.

IRS Sends Notice of New Reporting Requirement to Small Organizations

The IRS has begun issuing information letters to small tax exempt organizations notifying them of the reporting requirements enacted in the 2006 Pension Protection Act for organizations that do not meet the revenue threshold for required filing of the Form 990. The IRS expects to mail more than 650,000 letters about the new requirement which will take effect in 2008. Small organizations will be required to file an "e-postcard" that reports the name and mailing address of the organization, any other names used, a Web address if one exists, the name and address of a principal officer, and a statement confirming that the organization's annual gross receipts are normally $25,000 or less. An organization that does not satisfy this reporting requirement for three consecutive years will lose its tax exempt status.

Even though your exempt organization may not be required to file a Form 990, it may be required to submit a short report annually to the IRS.

IRS Issues Interim Guidance on Public Inspection of Forms 990-T

The IRS has released interim guidance in Notice 2007-45 related to the new requirement for section 501(c)(3) organizations filing unrelated business income ("UBI") tax returns (Forms 990-T) to make those returns available for public inspection. Until regulations are issued, taxpayers may rely on Notice 2007-45, which provides the following:

- An organization that files Form 990-T must make the return public, regardless of whether the organization is otherwise subject to public disclosure requirements. For example, churches that file Forms 990-T are subject to this requirement.
- The disclosure requirement applies to state colleges and universities (and their wholly-owned subsidiaries) that receive determination letters confirming that they are exempt under section 501(c)(3). However, it does not apply to institutions that are subject to unrelated business income tax solely because they are a state college or university.
- An organization that filed a 2006 Form 990-T only to request a telephone excise tax refund is not required to make that return available for public inspection and copying.
- The guidelines on making annual returns available, set forth in section Treas. Reg. section 301.6104(d)-1 generally apply, except that the definition of annual information return includes Form 990-T.
- Charities that make Form 990-T widely available in accordance with Treas. Reg. section 301.6104(d)-2 do not need to comply with an individual request for a copy of the return, although they must make it available for public inspection.
- The provisions of Treas. Reg. section 6104(d)-3 regarding harassing requests for copies also apply to a request for a charity's Form 990-T.

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