SOME IMPORTANT CONSIDERATIONS FOR NONPROFIT TAX-EXEMPT ORGANIZATIONS: A PRACTIONER'S GUIDE TO LEADING AND WORKING FOR A NONPROFIT

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INTRODUCTION

The growth of nonprofit organizations has accelerated over the past several years. These organizations employ a startling number of American workers, generate huge amounts of donations, and make a substantial amount of money. Consider the following: (1) In 1975 contributions to nonprofit organizations were estimated at $28.56 billion. By 2005 that number had climbed to $260.28 billion;[1] (2) It is estimated the nonprofit sector accounts for 5% -10% of the nation's economy and employs more workers than the real estate, insurance, finance, agriculture, mining, construction, transportation, and communication industries.[2] Therefore, there is a need for a better understanding of the law as it applies to nonprofit organizations by the average employee or director. This article does not attempt to be a complete treatise on this topic; rather it is simply an overview of a few selected areas that apply to many tax-exempt organizations.

This article is divided into four sections. The first simply defines nonprofit organizations while the remaining three each address a distinct topic. Section two is focused on how nonprofit organizations can maintain and benefit from their tax-exempt status. It highlights two areas: political activity by nonprofit organizations and title-holding corporations. Section three examines reporting requirements and some new tax laws for tax-exempt entities as introduced in the Pension Protection Act of 2006. Section four considers two leadership issues for nonprofit organizations. It focuses on director liability and duties as well as a brief overview of employment law issues for religious organizations.

[1] BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 29 (John Wiley & Sons 9th ed. 2007).
[2] *Id*. at 33.

DEFINITION OF "NONPROFIT ORGANIZATION"

For-profit organizations and nonprofit organizations have many similarities. Both are formed by filing the appropriate documents with the Secretary of State, and both can have the same basic leadership organization: directors who oversee the organization, and officers who run the day-to-day operations.[3]

A for-profit organization is primarily created to make a profit that is distributed to the shareholders through dividends. This distribution of income is called "inurement."[4] Contrary to popular thought, a nonprofit organization is allowed to make a profit, but the organization is *not* allowed to distribute any income or dividends to its owners, which in a nonprofit are normally the directors and officers.[5] The differentiating feature between nonprofit organizations and for-profit organizations is that nonprofit organizations can not engage in "private inurement."[6] Therefore, any profit made by a nonprofit organization must be reinvested in the organization and used to further its mission.

Some nonprofit organizations are not interested in tax-exempt status. However, a large portion of them do seek tax-exempt status under sections 501(c) or (d) of the Internal Revenue Code. Section 501(a) of the Internal Revenue Code allows for organizations listed in sections 501(c) or (d) to be tax exempt. Section 501(c) lists twenty-eight different types of nonprofit organizations that can qualify for tax exempt status. The most often used section, however, is 501(c)(3). Under this provision, the following qualify for tax-exempt status:

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[3] *Id*. at 4.
[4] *Id*. at 5.
[5] *Id*.
[6] *Id*.

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual . . . and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.[7]

Nonprofit organizations that achieve tax-exempt status under section 501(c)(3) are often referred to as "charitable" organizations even though they may be formed for religious, educational, scientific, or literary purposes. In this article, a "nonprofit organization" or "a 501(c)(3) organization", unless otherwise noted, refers to a tax-exempt charitable organization.

ENJOYING TAX EXEMPT STATUS

POLITICAL ACTIVITY

With the Presidential election season in full swing, many groups are actively joining in the campaign process in hopes of having their candidate elected. While an open and vigorously contested political process is welcome in this country, not every group can publicly voice their concern or approval for the candidates without possible consequences.

A charitable organization must not "participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office" in order to qualify as a tax-exempt organization with the federal government.[8] This ban applies to local, state, and federal

[7] 26 U.S.C.A. § 501(c)(3). 26 U.S.C.A. is hereafter referred to as I.R.C..
[8] I.R.C. § 501(c)(3).

campaigns and includes political activity in foreign countries.[9] In summary, a 501(c)(3) organization may not engage in activity that supports or opposes any candidate for a public office.[10]

According to the Internal Revenue Service, there are four main elements that tax-exempt organizations must be aware of and avoid to maintain their tax-exempt status when engaging in political activity:

1) participation or intervention in a
2) political campaign
3) or behalf of, or in opposition to a candidate
4) for public office

When first read these elements seem simple enough. However, upon closer inspection they are not as clear as first anticipated.

Participation or Intervention

Unfortunately, determining if a tax-exempt organization has intervened in a political campaign is not as simple as it may seem. To alleviate confusion, the IRS released a Fact Sheet in 2006[11] and followed that up with Revenue Ruling 2007-41.[12] These publications provide a tax-exempt organization guidance through this delicate process.

A broad analysis is necessary to determine if a tax-exempt organization is participating or intervening in a political campaign. The IRS has stated, "Whether an

[9] HOPKINS, *supra* note 1, at 678.
[10] 2008 IRS Phone Forum, "Rules for Exempt Organizations During an Election Year." www.irs.gov/pub/irs-tege/rulesforeosduringanelectionyearscript6-9-08.pdf (18).
[11] IRS Fact Sheet 2006-17. This fact sheet included 21 examples and some factors to be considered to determine if a 501(c)(3) organization had intervened in a political campaign.
[12] IRS Rev. Ruling 2007-41, as recorded in I.R.B. 2007-25 (June 18, 2007) was a written description of the 21 scenarios listed in IRS Fact Sheet 2006-17. http://www.irs.gov/irb/2007-25_IRB/ar09.html. According to the June 9, 2008 IRS phone forum "Rules for Exempt Organizations During an Election Year" it was written to provide a way for practicing attorneys to rely on those 21 examples as precedent. *See* www.irs.gov/pub/irs-tege/rulesforeosduringanelectionyearscript6-9-08.pdf (18).

organization is participating, or intervening, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office depends upon all of the facts and circumstances for each case."[13] For example, suppose First Church (which qualifies as a 501(c)(3) organization) prints in its weekly bulletin, "Please support our fellow member, X, this coming Tuesday in his race to be elected Judge of the 123rd District Court. Signed, Pastor Y." Is First Church participating or intervening in a political campaign? Most likely, yes. There are two probable violations: (1) no credit or support is given to any of X's opponent(s); and (2) the announcement is made in an official church publication.

First, the announcement in the weekly bulletin, will most likely be considered a "Get Out The Vote Drive." These are allowed if they are conducted in a "non-partisan manner," meaning that all candidates are mentioned.[14] However the ban is violated if the drive favors or prohibits one candidate over another.[15] In the example, because only one candidate, X, is mentioned, and people are encouraged to vote, this is an endorsement of a single candidate. Thus, First Church is engaged in political campaign intervention and is at risk of losing its tax-exempt status.

A second issue to be considered is where the announcement appears and how it is signed. According to the IRS, leaders of charitable organizations "cannot make partisan comments in official organization publications or at official functions of the organization."[16] The IRS would consider the bulletin an official church publication because the cost of printing is covered by the church. Also, Pastor Y is going to be

[13] IRS Revenue Ruling 2007-41, as recorded in I.R.B. 2007-25 (June 18, 2007). http://www.irs.gov/pub/irs-drop/rr-07-41.pdf
[14] IRS Revenue Ruling 2007-41, 2.
[15] *Id*.
[16] *Id*. at 4.

recognized as the leader of First Church. Therefore, since the endorsement by Pastor Y appears in an official publication, it constitutes campaign intervention by the church and its tax-exempt status is at risk.[17]

On the other hand, if Pastor Y attends a community function as an *individual* and not on behalf of the church, and endorses X as a candidate for the 123rd District Court, his actions will *not* be considered campaign intervention for three reasons. First, the endorsement is not in an official church publication. Second, it is not at an official church function. Finally, he is not speaking on behalf of the church.[18]

Or suppose, that X is a member at Second Church and is known by several members at First Church. First Church prints the following in its weekly bulletin followed by the names of all the candidates who are running: "Please support all of the candidates in their bid to be elected to the 123rd District Court next month. Voter registration cards are available in the foyer." Most likely this "Get Out the Vote Drive" will not violate the ban. Even though it appears in an official church publication, all of the candidates are mentioned; there is no reference to a political party nor is there an endorsement of a single candidate.[19]

The IRS has also provided guidance to determine if current elected officials are participating or intervening in a political campaign. For example, suppose a private university (which qualifies as a 501(c)(3) organization) invites the Governor, who is seeking a second term, to speak to the student body in his position as Governor and not as a candidate. Is the University participating or intervening in a political campaign? This will depend on the facts and circumstances under which the Governor is invited, what the

[17] *See Id.*, *See also,* Situation 5.
[18] *Id.*
[19] *See Id., See also,* Situation 1.

University communicates about him, and what the Governor does and says while there. "Political candidates may be invited in their capacity as candidates, or in their individual capacity (not as a candidate)."[20]

The Governor's presence alone does not cause the University to participate in a political campaign.[21] According to the IRS, there are several factors to consider when determining if the Governor's appearance violates the ban.[22]

- Whether the individual is chosen to speak solely for reasons other than candidacy for public office;
- Whether the individual speaks only in a non-candidate capacity;
- Whether the individual or any representative of the organization makes any mention of his or her candidacy or the election;
- Whether any campaign activity occurs in connection with the candidate's attendance;
- Whether the organization maintains a nonpartisan atmosphere on the premises or at the event where the candidate is present; and
- Whether the organization clearly indicates the capacity in which the candidate is appearing and does not mention the individual's political candidacy or the upcoming election in the communications announcing the candidate's appearance at the event.

Therefore, the University must be mindful of a how it portrays this visit so its tax-exempt status is not a risk. The University must clearly communicate that the Governor has been invited to speak as the Governor and not as a political candidate. The school should not restrict other political groups from being present during the Governors visit, nor should there be any campaign activity in connection with his visit. In addition, any communication by the University should not mention the Governor is seeking re-election. Finally, the Governor should be advised to speak "as the Governor" and not "as a political candidate."[23]

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[20] *Id*. at 5.
[21] *Id*. at 7.
[22] *Id*.
[23] *Id*.

Political Campaign

Next, the IRS will evaluate whether or not a tax-exempt organization is engaged in a "political campaign." A "campaign" is typically defined as "an effort which seeks to influence the decision making process within a specific group."[24] Neither the IRS[25] nor the Regulations have provided a definition of "political campaign."[26] However, there is guidance provided through case law. The Second Circuit, for example, has provided the following definition: "[A] campaign for public office in a public election merely and simply means running for office, or candidacy for the office, as the word is used in common parlance and as it is understood by the man in the street."[27]

Thus, if an ordinary person is led to believe that a candidate's actions are furthering a political campaign, the courts will rule likewise.

Political Candidate

The Internal Revenue Code does not define "candidate" to determine if a tax-exempt organization has participated or intervened in a political campaign.[28] However, the Treasury Regulations establish the term as "mean[ing] an individual who offers himself, or is proposed by others, as a contestant for an elective public office, whether such office be national, state, or local."[29]

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[24] http://en.wikipedia.org/wiki/Political_campaign
[25] HOPKINS, *supra* note 1, at 690.
[26] Gregory D. Baird, *Independent Institutions of Higher Education and I. R. C. § 501(c)(3): Guidelines for Conducting Political Campaign Activities on Campus*, 49 BAYLOR L. REV. 129, 138 (1997).
[27] Ass'n of the Bar v. Comm'r, 858 F.2d 876, 880 (2d Cir. 1988) (quoting Norris v. United States, 86 F.2d 379, 382 (8th Cir. 1936), *rev'd on other grounds*, 300 U.S. 564 (1937)). *Accord Id;* HOPKINS, *supra* note 1, 690.
[28] HOPKINS, *supra* note 1, at 690.
[29] 26 C.F.R. §1.501(c)(3)-1(c)(3)(iii) (2008). *Accord,* IRS Revenue Ruling 2007-41; Baird, *supra* note 26, at 135; HOPKINS, *supra* note 1, at 690.

Even given the previous definition, it is still not abundantly clear when an individual becomes a candidate for public office. But, it may be assumed that -

> [o]nce an individual declares his candidacy for a particular office, his status as a candidate is clear. . . . On the other hand, the fact that an individual is a prominent political figure does not automatically make him a candidate, even if there is speculation regarding his possible future candidacy for particular offices."[30]

Thus, a member of cogress is not going to be considered a candidate for public office because he is not seeking to be elected; he has already been elected. But, if a member of cogress has a committee formed to explore his options for the next election, he may be considered a candidate.[31]

Public Office

There is insufficient information available to determine what exactly is meant by the term "public office" as it relates to the ban in 501(c)(3).[32] This does not mean, however, that there is no guidance at all. An "elective public office" is discussed by the Internal Revenue Service in the rules for private foundations and in their discussion of a "disqualified person."[33]

> [S]everal factors may be considered as indications that a position in the executive, legislative, or judicial branch of the government of a State, possession of the United States, or political subdivision … constitutes a public office. Among such factors to be considered … are that the office is created by the Congress, A State constitution, or the State legislature, or by a municipality or other governmental body pursuant to authority conferred by the Congress, State constitution, or State Legislature, and the powers conferred on the office than the duties to be discharged by such office are defined either directly or indirectly by the Congress,

[30] HOPKINS, *supra* note 1, at 690. (citing *Lobbying and Political Activities of Tax-exempt Organizations* 14: Joint Committee on Taxation, Mar. 11, 1987).
[31] Baird, *supra* note 26, at 136.
[32] HOPKINS, *supra* note 1, at 690.
[33] HOPKINS, *supra* note 1, at 691. (citing Internal Revenue Code §§ 4946(c)(1), (5)).

> State constitution, or State legislature, or through legislative authority.[34]

In an effort to provide clarity, a two courts have given some instruction. A Michigan Appellate court relied on common statutory construction rules[35] and held, "[L]ogically most people would believe that if an individual's name is listed on an election ballot, that individual is a candidate for something."[36] Similarly, the Second Circuit has held the term "political candidate" should be "used in common parlance and as it is understood by the man on the street."[37]

Finally, the IRS pronounced "[to the average person] the appearance of precinct candidates on the general election ballot indicates that the position is a public office."[38] Therefore, it can be concluded that if a person's name appears on a ballot then they are a political candidate for the purposes of 501(c)(3).

Accordingly, to preserve their tax-exempt status, nonprofit organizations should carefully consider these elements before engaging in any political activity.

TITLE HOLDING CORPORATION

Single-Parent Organizations

For many tax-exempt organizations the single greatest asset they own is the building they meet or work in. To fully protect themselves, some tax-exempt organizations may find they want to limit their liability for their real estate and other assets. This can be accomplished though a 501(c)(2) organization. This organization is

[34] HOPKINS, *supra* note 1, at 691. (citing Reg. § 53.4946-1(g)(2)(i)).
[35] Statutory words and phrases should be construed according to their common meaning.
[36] Templin v. Oakland County Clerk, 387 N.W.2d 156, 159 (Mich. Ct. App. 1986).
[37] Ass'n of the Bar of the City of New York v. Comm'r, 858 F.2d 876, 880 (2d Cir. 1988), 490 U.S. 1030 (1989).
[38] HOPKINS, *supra* note 1, at 692 (citing Internal Revenue Code Gen. Couns. Mem. 39811).

not required to pay federal tax and provides a tax-free method of protecting and managing real estate and other assets.[39]

A 501(c)(2) organization can accomplish other things than limited liability. For example, there is an enhanced ability to borrow, accounting is simplified, title of the property is clear, and it allows a tax-exempt organization to accept gifts that are required to be kept as separate entities.[40]

An overriding principle of 501(c)(2) organizations is that they are only allowed to hold title to property that would normally be held by the parent organization and turn over any net income, minus expenses,[41] from the property to the parent organization.[42] The IRS stated a 501(c)(2) organization "by its nature [is] responsive to the needs and purposes of its exempt parent which established it mainly to facilitate the administration of properties."[43]

Notice that a title-holding company, by definition, is only allowed to hold title to property; it is generally not allowed to generate income, however, there are a few exceptions.[44] Perhaps the most widely used exception, and the one most applicable to this article, is income from rental property. According to the Internal Revenue Service, "A title holding corporation that derives income from rental of real property to the general public is not precluded from exemption under section 501(c)(2) of the Code."[45] In other words, a title-

[39] *See* http://www.t-tlaw.com/tx-02.htm.
[40] http://www.irs.gov/pub/irs-tege/eotopicc86.pdf, (2).
[41] "Expenses include[] the operating costs that could be deductible by a taxable corporation." This includes depreciation but not corporate deductions such as charitable contributions. Revenue Manual (IRM) Online, pt. 7, ch. 25, sec. 2.6.3 (11-28-1997) – 1.A. http://www.irs.gov/irm/part7/ch10s02.html
[42] 26 C.F.R. § 1.501(c)(2)-1(b) (West 2008).
[43] Rev. Rul. 77-429, 1977-2 C.B. 189.
[44] For example, a 501(c)(2) organization is allowed to keep part of its income and apply it to any debt on the property. *Id*.
[45] Rev. Rul. 69-381, 1969-2 C.B. 113. *See Also*, HOPKINS, *supra* note 1, at 503.

holding company can rent out the property for which it holds title, and the income derived from rental payments will *not* be considered as unrelated business income.[46]

Unrelated business taxable income (UBTI) is income that comes from activities the tax-exempt organization is engaged in that do not make up a *substantial portion* of the organization's overall activities.[47] The IRS states, "[UBTI] means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business. . . ."[48] To determine what constitutes a substantial portion of an organizations activity it is helpful to calculate how much time and energy these activities are consuming from paid staff or volunteers.[49] Often, a tax-exempt organization will have some income that is not derived from their tax-exempt activities; this is how a lot of tax-exempt organizations make enough money to operate. But, this income is going to be taxed as though the organization was designed to make a profit.[50]

The following example shows one way a 501(c)(2) will be valuable to a tax-exempt organization. Suppose a local tax-exempt organization, First Charity, has real estate which it uses for office space. However, because the building is too large to be fully utilized by First Charity, the board of directors has determined to lease some of the space. The directors, wanting to protect First Charity against liability if any of their lessees get into legal trouble, seek legal counsel. First Charity should be advised to create a title-holding corporation that will simply hold title to its office building. This will protect it from liability and will

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[46] HOPKINS, *supra* note 1, at 503. *See also* Rev. Rul. 69-381, 1969-2 C.B. 113 (holding Section 512(b)(3) of the Code excludes from the determination of unrelated business taxable income rents from real property.)
[47] ANTHONY MANCUSCO, HOW to FORM a NONPROFIT CORPORATION 17 (Diana Fitzpatrick ed., Delta Printing Solutions 8th ed. 2007) (1990).
[48] I.R.C § 512(a)(1) (West 2008).
[49] MANCUSCO, *supra* note 47, at 17, 49.
[50] *Id*. at 17, 80.

generate some income. The title holding corporation will be a subsidiary of First Charity, and its tasks will be to hold title to the building, collect the rent paid by the lessees, pay any expenses derived from the rental of the building, and turn over the remainder of the income to First Charity. First Charity does not have to worry about the income generated from the rental of the property being considered as unrelated business income (UBTI) because "there were no substantial services to the tenants."[51]

Now, assume First Charity has a large moving truck it wishes to rent out to assist those who are leasing space in their building. Again, not wanting to be liable for the lessee's torts, it forms another title holding company that holds title to the truck. The income derived from renting the truck *will be* considered unrelated business income because the truck is personal property and is unrelated to the lease of the building.[52] Therefore, the allowance of a title holding company to generate income and pass it along to the parent organization tax free is only allowed when (1) the property being leased is real property, or (2) in the case of personal property, it is connected with the real property.[53] "[A] title-holding organization that engages in business activity – other than the rental of real property – may be denied or lose tax exemption."[54]

Another way a 501(c)(2) organization can hold title to property and pass the income on to the parent organization is through stocks and bonds. The income from these investments is not prohibited by the Treasury Regulations.[55] The Internal Revenue Service has stated, "Clearly, an organization exempt under IRC 501(c)(2) may invest in stocks and bonds and passively collect the income from these investments. However,

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[51] *Id*.
[52] Rev. Rul. 69-278, 1969-1 C.B. 148.
[53] *Id*.
[54] HOPKINS, *supra* note 1, at 503.
[55] Internal Revenue Manual (IRM) Online, pt. 7, ch. 25, sec. 2.4.1 – 1.A. http://www.irs.gov/irm/part7/ch10s02.html

permissible investment activities should be distinguished from the active 'business' of securities trading."[56]

Multiple Parent Organizations

The title-holding organization under 501(c)(25) works just like the 501(c)(2) organization except the parent organization is a tax-exempt corporation or trust and the title-holding company remits any income, less expenses "to one or more qualified tax-exempt organizations that are shareholders of the title-holding corporation or beneficiaries of the title-holding trust."[57]

There are, however, a couple of important issues to consider when there are multiple parents of a title-holding company. First, a title-holding company will not continue to qualify as a tax-exempt organization if one of its parents does not qualify.[58] Second, a title-holding company is subject to UBTI if one of its parents is subject to UBTI.[59]

In sum, these title holding organizations can be a great tool to protect the assets of a tax-exempt organization.

PENSION PROTECTON ACT OF 2006

The Pension Protection Act of 2006 (PPA) was signed into law by President Bush on August 17, 2006 and was primarily intended to protect pensions of American

[56] *Id*.
[57] I.R.C. § 501(c)(25)(A)(iii). *See also* HOPKINS, *supra* note 1, at 505.
[58] Rev. Rul. 68-371, 1968-2 C.B. 204.
[59] Rev. Rul. 68-490, 1968-2 C.B. 241.

workers.[60] However, the bill also included a host of other provisions leading one commentator to quip, "It could have been called the Miscellaneous Reform Act of 2006."[61] The first line of the act even admits the other reforms when it states its purpose is "to provide economic security to all Americans *and for other purposes*."[62] "Other purposes" of the PPA include, modernization of the Tax Court,[63] technical corrections to the Mine Safety Act,[64] and suspending the tariff duties on ceiling fans.[65]

Title XII of the act, Reforms for Exempt-Organizations, was driven in large part by Republican Senator Chuck Grassley from Iowa. As the senior Republican member of the Finance Committee, he led the "white paper" plan: a "wish list" for charitable reforms.[66] Therefore, sandwiched in the middle of the PPA is a section of reforms aimed towards tax-exempt organizations; this title of the act is most applicable to this article.[67] For the purposes of this article, only four will be considered because they apply to the large majority of tax-exempt organizations in existence.

Sec. 1217. Modification of Recordkeeping Requirements for Certain Charitable Contributions

As seen by the huge amounts of money donated to charities over recent history, it is clear that many tax payers use these donations for deductions on their income taxes. Previously, when an individual made a donation, regardless of the amount, they were

[60] Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 1081 (codified as amended in scattered sections of 26 U.S.C.A.) (West 2008).
[61] http://www.asaecenter.org/PublicationsResources/whitepaperdetail.cfm?ItemNumber=24188
[62] Pension Protection Act of 2006, *supra* note 60, (emphasis added).
[63] *Id*. Title VIII, chapter E.
[64] *Id*. Title XIII chapter A.
[65] *Id*. Title XIV, chapter B.
[66] www.hansonbridgett.com/docs/newsletters/exempt_organizations_update/HB_ExemptOrgSep2006.pdf
[67] *See* Pension Protection Act of 2006, *supra* note 60, Title XII.

allowed to use one of three methods to substantiate their donation for deduction purposes. (1) a cancelled check; (2) a receipt or letter or other communication from the donee (receiving) organization showing the name of the donee, the date and amount of the donation; or (3) a reliable written record showing the date and amount of the contribution. Often the "written record" was a self-made memo by the donor with information regarding the donation. The donor could use this method if one of the previous two methods was not available.[68]

Or if the amount of charitable gift was over $250 the taxpayer was required to substantiate their contribution with a "contemporaneous writing"[69] from the donee that stated the amount of cash, description of the property other than cash, whether the donee provided and goods or services in consideration for the contribution, and a good faith estimate of the value of any goods or services, if they were provided.[70]

Now, after the PPA, a donor can only substantiate her donation of money (regardless of the amount) by either a (1) cancelled check; or (2) a written communication from the donee showing the name of the donee organization, the date of donation, and amount of the contribution. No longer can a donor rely on "other written records" such as her own memo or receipt to substantiate her donation. This provision "more closely aligns the substantiation rules for money to the substantiation rules for

[68] Treas. Reg. § 1.170A-13(a)(1)(iii) (West 2008).
[69] A writing is considered to be contemporaneous if the taxpayer obtains it on or before the earlier of (1) the date on which the taxpayer files a return for the taxable year in which the contribution was made, or (2) the due date (including extensions) for filing such a return. I.R.C. § 170(f)(8)(C) (West 2008).
[70] Treas. Reg. sec. 1.170A-13(b) (West 2008). *See also* IRC §170(f)(8) (West 2008).

property. . . ."[71] The substantiation requirements for donations over $250 are still required.

What does this mean for charitable organizations and those who donate to them? First, charitable organizations must be prepared to provide donors with a contemporaneous writing for their donation.[72] This means these organizations must implement procedures that will allow them to correctly record how much donors give and provide a report to them in a timely manner.

Second, donors must keep track of how much they donate to charitable organizations and make sure they receive a report from those organizations reporting how much they donated during the year. These steps will allow donors to substantiate their donations for income tax deduction purposes.

Sec. 1216. Limitation of deduction for charitable contributions of clothing and household items.

Some donors see tax-exempt organizations as a way to get rid of unwanted items; they clean out their closets and cabinets and take it all to a local charity so they can receive a tax deduction for all of the used clothes and other items. Wanting to curb this practice, Congress tightened the rules for donations of clothing and household items[73] with a specific provision. The new provision provides that no deduction for household

[71] JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF H.R. 4, THE "PENSION PROTECTION ACT OF 2006" AS PASSED BY THE HOUSE ON JULY 28, 2006, AND AS CONSIDERED BY THE SENATE ON AUGUST 3, 2006 (JCX-38-06), 305-06, (August 3, 2006).
[72] *See* Pension Protection Act of 2006, *supra* note 60, Title XII.
[73] Household items include furniture, furnishings, electronics, appliances, linens and other similar items. Not included are food, antiques, paintings, other projects of art, jewelry, gems, and collections. Pension Protection Act of 2006, *supra* note 60, Title XII, Subtitle B, pt. 1, sec. 1216.

items or clothing will be allowed "unless such clothing or household item is in good used condition or better."[74]

Congress even went so far as to stop donors from donating items that have minimal use and then claiming a deduction. In the "Items of Minimal Value" clause the Secretary may deny a deduction of any clothing or household item that has "minimal monetary value."[75] According to the Joint Committee on Taxation, this means that "used socks and undergarments" may no longer qualify for tax deductions.[76]

However, not all is lost when it comes to donating used clothing or household items. If a donor gives a single item of clothing or a household item the donor can claim a deduction for that amount if it is accompanied with a qualified appraisal stating the item's value is greater than $500.[77]

Sec. 1215. Recapture of Tax Benefit for Charitable Contributions of Clothing and Household Items.

Some donors seeking a tax deduction take give large value items to charitable organizations without doing much research on whether the organization actually needs them. This practice creates problems for the donor if the organization determines they do not need the donated property and disposes of it.

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[74] Pension Protection Act of 2006, *supra* note 60, Title XII, Subtitle B, pt. 1, sec. 1216. *See also* I.R.C. § 170(f)(16)(A) (West 2008).
[75] *Id*.
[76] JOINT COMMITTEE ON TAXATION, *supra* note 71, at 314.
[77] Pension Protection Act of 2006, *supra* note 60, Title XII, subtitle B, pt. 1, sec. 1216. *See also* I.R.C. § 170(f)(16)(C) (West 2008).

For donated property valued at more than $5000 the donor must follow steps outlined by the IRS to enjoy a deduction. Primarily, the donor is required to attach an appraisal summary of the item to their tax return.[78]

Before the PPA the donor did not face any adjustment of his claimed tax benefit if the donee organization disposed of the donated property within two years. If the organization determined it did not need or want the donated property it simply filed a tax return and provided a copy to the donor.

After the PPA, the donor tax payer now faces an adjustment to his or her deduction.

> [T]he provision recovers the tax benefit for charitable contributions of tangible personal property with respect to which a fair market value deduction is claimed and which is not used for exempt purposes. The provision applies to appreciated tangible personal property that is identified by the donee organization, for example on the Form 8283, as for a use related to the purpose or function constituting the donee's basis for tax exemption, and for which a deduction of more than $5,000 is claimed ("applicable property").[79]

Some specific modifications need to be highlighted. First, if a *donee* organization sells or disposes of the donated property within three years of the donation date, the *donor* may have to make an adjustment in the amount he deducted from his income because of the donation. This changes both the time period in which the donee organization can dispose of the property and brings the donor into the equation when it

[78] I.R.C. §170(f)(11)(C) (West 2008). The I.R.C. §170(f)(11)(E) points the reader to the Treasury Regulations for a detailed explanation of a qualified appraisal. *See* Treas. Reg. § 1.170A-13(c)(3) (West 2008). A qualified appraisal is (1) one that is prepared not earlier than 60 days prior to the date of donation of the appraised property and not later than the due date of the return on which a deduction is first claimed under section 170; (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of the property when contributed and the specific basis for the valuation; (c) a statement that the appraisal was prepared for tax purposes; (d) the qualifications of the appraiser; and (e) the signature and tax identification number of the appraiser; and (4) does not involve an appraisal fee that violates proscribed rules.

[79] JOINT COMMITTEE ON TAXATION, *supra* note 71, at 300.

does so.[80] If the property is disposed of in the *same* tax year as when the donation was made the donor deduction is no longer fair market value[81] but now his basis.[82] However, according to the Joint Committee on Taxation, if the donated property is disposed of in a year *other* than the year of donation the donor must now,

> [I]nclude as ordinary income for its taxable year in which the disposition occurs an amount equal to the excess (if any) of (i) the amount of the deduction previously claimed by the donor as a charitable contribution with respect to such property, over (ii) the donor's basis in such property at the time of the contribution.[83]

However, the taxpayer will *not* be subject to any adjustment if the donee organization follows certain procedures. If the donee provides a certification to the Treasury Secretary that certifies (1) the use of the property by the charitable organization was related to the mission of the organization and how the donated property benefitted that mission. Or, (2) if the organization states the intended use of the property was related to its overall mission but that use became "impossible or infeasible to implement."[84] In other words, the donor will not be subject to an adjustment in his tax return if the property was given for a purpose in line with the overall mission of the charitable organization and that property was later disposed of. This prevents donors from giving tangible personal property to a charitable organization for which the organization has no use. But a strict penalty of $10,000 is applied to a person who gives

[80] Recall that previously a donee could dispose of property within *two* years and the donee only had to file a return; the donor was not implicated at all.
[81] "The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." 26 C.F.R. § 20.2031-1(b) (2007).
[82] JOINT COMMITTEE ON TAXATION, *supra* note 71, at 300. "The basis of property is the cost of such property . . . ." I.R.C. § 1012.
[83] *Id*. at 301.
[84] *Id*.

property stating it is for a particular use by the charitable organization knowing that the property is *not* intended for that use.[85]

Sec. 1223. Notification Requirement for Entities not Currently Required to File.

While tax-exempt organizations are generally free from tax burdens,[86] most must file an annual information return such as Form 990 or Form 990-EZ. As with many tax regulations, there are some exceptions (most of which deal with churches or their auxiliaries.) Churches, integrated auxiliaries of churches, conventions or associations of churches, and schools below college level affiliated with church or operated by a religious order are not required to file.[87] Before the PPA, charitable organizations who had gross receipts[88] less than $25,000 were not required to file an informational return.

With the passage of the PPA, organizations that were previously excused from filing an informational return because they did not have gross receipts in excess of $25,000[89] are now required to file. Their filing, known as the 990-N, is to be done electronically and contains basic information regarding the organization. Required information includes the legal name of the organization, any name under which the organization operates or does business, the organization's mailing address and Internet

[85] *Id*. *Accord*, Pension Protection Act of 2006, *supra* note 60, Title XII, Subtitle B, pt. 1, sec. 1215; I.R.C. § 6720B (West 2000).
[86] Although some may be required to file a return for Unrelated Business Tax.
[87] INTERNAL REVENUE SERVICE, PUBLICATION 557 - TAX EXEMPT STATUS FOR YOUR ORGANIZATION 9, (June 2008).
[88] Gross receipts are the total amounts the organization received from all sources during its annual accounting period, without subtracting any costs or expenses. http://www.irs.gov/charities/article/0,,id=177784,00.html
[89] "An organizations gross receipts are considered to be $25,000 or less if the organization has (1) been in existence for one year or less and received, or donors have pledged to give $37,500 or less during the organizations first year; (2) Has been in existence between 1 and 3 years and has averaged $30,000 or less in gross receipts during each of it's first two tax years; or (3) Is at least 3 years old and has averaged at least $25,000 or less in gross receipts for the immediately proceeding 3 tax years (including the year for which calculations are being made)." http://www.irs.gov/charities/article/0,,id=177338,00.html.

web site (if any), the organization's tax identification number, the name and address of a principle officer, and evidence of the organizations continuing basis for its exemption from the filing requirements. Also, if the organization determines it will no longer operate, it is required to furnish notice of its termination.[90] Like before, there are some groups that are exempt from this new filing requirement. For example, the Internal Revenue Service has declared that "churches, their integrated auxiliaries, conventions or associations, and organizations that are included in a group return are not required to file Form 990-N."[91]

Showing it is serious, Congress approved a stiff penalty for those who ignore the new filing requirements: loss of their tax-exempt status.[92] But, in an effort to show some leniency, the Internal Revenue Service will not apply this penalty unless a tax-exempt organization does not file for three consecutive years.[93] Revocation will apply from the date the Secretary of the Treasury determines as the time for the filing of the third year.[94] If an organization does suffer such punishment, they are able to file for reinstatement.[95] Furthermore, if the organization is able to show reasonable cause why they did not timely file, the Secretary may reinstate their tax-exempt status retroactive to the day it was revoked.[96]

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[90] JOINT COMMITTEE ON TAXATION, *supra* note 71, at 326. *Accord*, Pension Protection Act of 2006, *supra* note 60, Title XII, Subtitle B, Part 1, sec. 1223; I.R.C. § 6033(a)(i)(1); INTERNAL REVENUE SERVICE, PUBLICATION 557 - TAX EXEMPT STATUS FOR YOUR ORGANIZATION 9, (June 2008).
[91] INTERNAL REVENUE SERVICE, PUBLICATION 557 - TAX EXEMPT STATUS FOR YOUR ORGANIZATION 9, (June 2008).
[92] Pension Protection Act of 2006, *supra* note 60, Title XII, Subtitle B, Part 1, sec. 1223. *See also*, I.R.C. § 6033(b).
[93] Pension Protection Act of 2006, *supra* note 60, Title XII, Subtitle B, Part 1, sec. 1223. *See also*, I.R.C. § 6033(j).
[94] *Id*.
[95] *Id*.
[96] *Id*.

A tax-exempt organization will want to ensure it knows precisely when their informational return (Forms 990, 990-EZ, 990-PF or 990-N) is due. These forms are due on the fifteenth day of the fifth month after the end of the organizations accounting period.[97] Thus, if the organization's tax or accounting year ends on December 31, then these forms are due on May 15 of the following year.

LEADERSHIP ISSUES

DIRECTOR LIABILITY

As with all corporations and organizations, there must be a governing body that directs the organization. Typically, the articles of incorporation will create a board of directors.[98] The directors take on fiduciary responsibilities which must be followed so they are not liable for acts of the corporation. A fiduciary is defined as,

> A person who is required to act for the benefit of another person on all matters within the scope of their relationship; one who owes to another the duties of good faith, trust, confidence, and candor. . . [Or] [o]ne who must exercise a high standard of care in managing another's money or property . . . .[99]

In its simplified form, if an individual has a fiduciary duty, then she must act for someone else's benefit while putting her personal interest aside. A fiduciary duty is the highest duty in the law - one that cannot be overlooked or breached. There are three main fiduciary duties for nonprofit corporations: the duty of care, duty of loyalty, and duty of obedience.[100]

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[97] INTERNAL REVENUE SERVICE, PUBLICATION 557 - TAX EXEMPT STATUS FOR YOUR ORGANIZATION 9, (June 2008).
[98] TEX. BUS. ORGS. CODE ANN. § 22.201 (Vernon 2007). It is possible for a nonprofit organization to be member managed but this is not likely except in some small religious organizations. *See* § 22.202.
[99] BLACK'S LAW DICTIONARY (Westlaw.com, query for "fiduciary") (8th ed. 2004).
[100] HOPKINS, *supra* note 1, at 135-36. *Accord* DARREN B. MOORE, GOVERNANCE OF NONPROFIT ORGANIZATIONS COURSE: NONPROFIT DIRECTOR AND OFFICER LIABILITY (Texas Bar CLE) 2 (2007); Gearhart Indus. Inc., v. Smith Intern, Inc., 741 F.2d 707, 719 (5th Cir. 1984) (applying Texas law).

Duty of Care

At its most basic level, the duty of care requires the board of directors, collectively and individually, to stay informed about the organization's activities and operations.[101] Typically it calls for a director to act in good faith, with ordinary care, and in the best interest of the corporation.

Good Faith

Generally, an individual acts in good faith when she acts honestly in belief or purpose, faithfully carries out her obligation, and does not have the intent to defraud or take advantage of another.[102] It is helpful to contrast this with "bad faith." A state appellate court has stated that a fiduciary acts in "bad faith" when one "acts out of a motive of self gain."[103]

Ordinary Care

A Director must ensure she acts with ordinary care as she fulfills her obligations to the organization. "Ordinary care requires the director to exercise the degree of care that a person of ordinary prudence would exercise in the same or similar circumstances."[104] However, if a board member has special expertise (such as an accountant, lawyer, or financial consultant) she is to exercise the degree of care that another person with that expertise would show in a similar situation.[105] Ordinary care is satisfied when the director prepares for and regularly attends board meetings, and makes

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[101] HOPKINS, *supra* note 1, at 135.
[102] BLACK'S LAW DICTIONARY (Westlaw.com, query for "good faith") (8th ed. 2004).
[103] MOORE, *supra* note 100, at 2 (citing Bohatch v. Butler & Binion, 905 S.W.2d 597, 602 (Tex. App. – Houston [14th Dist.] 1995) *aff'd* 977 S.W.2d 543 (Tex. 1998)).
[104] MOORE, *supra* note 100 at 2.
[105] *Id*.

well-informed decisions regarding the business at hand.[106] Consequently, a director who is rarely present at meetings, or never prepares in advance, nor participates in the meeting, is not exercising ordinary care.

One of the primary methods of preparation is to review the meeting agenda and any necessary information prior to the meeting; this allows the director to make the best possible decision. Directors may, in good faith, rely on information, opinions, reports, or statements including financial statements that were prepared or presented by an employee of the organization, a person whom the director reasonably believes to have professional expertise in the matter, legal counsel, CPA, or a committee of the board of directors of which the individual director is not a part of.[107] Or, in the case of a religious corporation, the director may rely on information presented or prepared by a religious authority, or "a minister, priest, rabbi, or other person whose position or duties in the religious organization the directors believes justify reliance and confidence and whom the director believes to be reliable and competent in the matters presented."[108]

Additionally, to satisfy their duty of care, directors should also periodically examine the performance of the officers of the organization and make sure the organization complies with any filing requirements.[109]

In the Best Interest of the Corporation

Next, the directors must make decisions in a manner they reasonably believe are in the best interest of the corporation.[110] In other words, the director must put the

[106] HOPKINS, *supra* note 1, at 135. *See also*, MOORE, *supra* note 100, at 2.
[107] TEX. BUS. ORGS. CODE ANN. § 3.102 (Vernon 2007).
[108] *Id*. at § 22.222.
[109] HOPKINS, *supra* note 1, at 135.
[110] *Id*. at § 22.221. *See also* TEX. REV. CIV. STAT. ANN. Art. 1396-2.28 (Vernon 2007).

interests of the organization above any competing interests and work to serve the organization only.

Business Judgment Rule

In Texas and some other jurisdictions[111] the business judgment rule will protect directors from "bad decisions" if they use their business judgment to make decisions for the organization.[112] In its basic form, the business judgment rule provides a court will not second guess a decision by the board of directors if the decision was made in good faith, with ordinary care, and in the best interest of the corporation.[113] Therefore, directors are free from judicial review in cases brought by the members of the organization if they exercise the duty of care.[114]

Duty of Loyalty

Commentators agree that the duty of loyalty requires directors to act in the best interest of the corporation (or tax-exempt organization) and not for their own personal interest.[115] The duty of loyalty is satisfied when directors disclose any conflict of

[111] *See* COMMITTEE ON NONPROFIT CORPORATIONS, GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS 28 (George W. Overton, Jeannie Carmedelle Frey, eds., American Bar Association 1993) (2nd ed. 2002).
[112] *See* MOORE, *supra* note 100, at 3 (citing Campbell v. Walker, 2000 WL 19143 at *10, 11 (Tex. App. – Houston [14th Dist.] 2000 *no pet*)).
[113] Gearhart Indus. Inc., v. Smith Intern, Inc., 741 F.2d 707, 721 (5th Cir. 1984).
[114] Notice the Texas Nonprofit Corporation Act and the Texas Business Organization code simply restate the duty of care in their appropriate sections. *Accord* TEX. BUS. ORGS. CODE ANN. § 22.221 (Vernon 2007); TEX. REV. CIV. STAT. ANN. Art. 1396-2.28 (Vernon 2007).
[115] *See* HOPKINS, *supra* note 1, at 135. *Accord* MOORE, *supra* note 100, at 5; MASSACHUSETTS CONTINUING LEGAL EDUCATION, INC., GUIDEBOOK FOR BOARDS OF DIRECTORS MASSACHUSETTS NONPROFITS Vol. 1 §3.1(b) (Jack M. Reilly) (2005).

interest, do not participate in corporate opportunities, and do not disclose the organization's confidential information.[116]

Conflict of Interest

To be free from a conflict of interest a director must not enter into a contract between the organization and himself.[117] According to the Committee on Nonprofit Corporations, "A conflict of interest is present whenever a director has a material personal interest in a proposed contract or transaction to which the corporation may be a party."[118] A Texas appellate court has identified four situations when a director is "interested." These include instances when the director:

1. makes a personal profit from the transaction with the corporation;
2. buys or sells assets of the corporation;
3. transacts business in the officer's or director's capacity with a second corporation of which the officer or director has a significant financial interest; or
4. transacts corporate business in the officer's or director's capacity with a member of his or her family.[119]

Specific to nonprofit organizations, a conflict of interest may also arise from a director's previous service to other nonprofit organizations. Therefore, it is important for a director to disclose all possible conflicts between the organization he or she is presently working for, and any previous organizations served.[120]

A possible conflict of interest does not prohibit a director from conducting business with the organization. Texas has adopted a method for a particular contract that

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[116] *See* HOPKINS, *supra* note 1, at 135. *Accord* MOORE, *supra* note 100, at 5; COMMITTEE ON NONPROFIT CORPORATIONS, GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS 29 (George W. Overton, Jeannie Carmedelle Frey, eds., American Bar Association 1993) (2nd ed. 2002).
[117] MOORE, *supra* note 100, at 5. These transactions are also known as "interested transactions."
[118] COMMITTEE ON NONPROFIT CORPORATIONS, *supra* note 111, at 30.
[119] Loy v. Harter, 128 S.W.3d 397, 407-08 (Tex. App. – Texarkana 2004).
[120] COMMITTEE ON NONPROFIT CORPORATIONS, *supra* note 111, at 30.

would otherwise be void because of an interested director. This contract between a director and the organization can be valid if:

> [T]he material facts . . . are disclosed or are known to the board of directors, the committee, or the members, and the board, committee, or members, in good faith and with ordinary care authorize[] the contract or transaction by the affirmative vote of a majority of the disinterested directors or members . . . .[121]

Corporate Opportunity

An opportunity belongs to the organization where there is a "legitimate interest or expectancy in" the opportunity and the organization has the financial ability to take advantage of it.[122] If a Director comes across an opportunity which may be of interest to the organization he serves, he has a duty to inform the organization before he can take advantage of it personally. [123] This duty arises when the director learns of the opportunity while conducting business for the organization, or because of their position as a director for the organization. However, the director can personally take advantage of the opportunity, after disclosure, if he can show the organization either lacked the financial ability to take advantage of the opportunity, abandoned the opportunity, or the was in a different "line of business" than the opportunity.[124]

For example, suppose a Director for Charity One is a real estate developer. Charity One is looking to buy some land for a new building and the Director is charged with finding some appropriate real estate. The Director comes across some land that would make an ideal location for a new subdivision from which he would personally profit. But he finds this land from a donor of Charity One who is interested in selling to

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[121] TEX. REV. CIV. STAT. ANN. Art. 1396-2.30. *Accord*, TEX. BUS. ORGS. CODE ANN. § 22.230 (Vernon 2007).; COMMITTEE ON NONPROFIT CORPORATIONS, *supra* note 111, at 30 – 33.
[122] MOORE, *supra* note 100, at 5.
[123] COMMITTEE ON NONPROFIT CORPORATIONS, *supra* note 111, at 34.
[124] *Id*.

the charity. The problem is Charity One does not have the financial ability to purchase the land. The Director would love to buy the land with his own company and develop it, but he has come across a corporate opportunity that must be disclosed to Charity One. Once the conflict is disclosed and the board agrees that it is out of the its price range, the Director is free to buy the land with no conflict. However, if the Director keeps the land a secret from Charity and purchases it with his own company, he has committed a breach of his duty of loyalty.

Confidential Information

Directors are also charged with a duty to keep information about the nonprofit organization confidential unless it is public knowledge, or the organization gives the director permission to disclose it.[125] Information should only be brought to the public through two avenues: (1) By individuals who have been given permission to share it; or (2) by the spokesperson for the organization. Usually this will be the Chairman of the Board, the CEO, or the public relations officer.[126]

Duty of Obedience

The duty of obedience requires directors to (1) comply with all federal, state, and local laws; (2) adhere to the organizations bylaws and articles of incorporation; and (3) carry out the mission and goals of the organization.[127] This means a director should regularly review the governing documents of the organization so he can be familiar with them. Also, directors should understand the mission of the organization and make

[125] MOORE, *supra* note 100, at 6. *See also*, COMMITTEE ON NONPROFIT CORPORATIONS, *supra* note 111, at 34.
[126] COMMITTEE ON NONPROFIT CORPORATIONS, *supra* note 111, at 34.
[127] MOORE, *supra* note 100, at 6. *Accord*, HOPKINS, *supra* note 1, at 135-36; MASSACHUSETTS CONTINUING LEGAL EDUCATION, INC, *supra* note 115.

decisions which fulfill that mission.[128] Finally, they should ensure that restrictions imposed by donors are followed and all reporting requirements of the organization are met.[129]

EMPLOYMENT LAW FOR RELIGIOUS ORGANIZATIONS

According to some of the latest statistics, the nonprofit sector employs 8% of the Unites States "noninstitutional civilian employees."[130] This may not seem like a large amount, but considering this accounts for more civilian employees than all state governments and the federal government combined,[131] the number becomes much larger.

Given the number of people employed by nonprofit organizations, it is fitting to focus some time on employment issues. Generally speaking, working for a nonprofit is not much different than working for a for-profit corporation. Of course, some potential employees believe working for a nonprofit will mean they will not make much money; or at the very least, they will make much less than they would in the for-profit sector. While this is true to some extent, it is not always the case. Congress has accepted that a nonprofit employee will not necessarily be paid less just because they work for a tax-exempt organization rather than a taxable organization.[132] Employees of religious organizations need to be aware of some potential issues

Title VII is a large body of law that generally applies to both nonprofit and profit making corporations. Commonly known as an anti-discrimination statute, it clearly states:

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[128] HOPKINS, *supra* note 1, at 136.
[129] MOORE, *supra* note 100, at 6.
[130] HOPKINS, *supra* note 1, at 33.
[131] *Id*.
[132] *Id*. (citing H.R. Res. 104-506, 104th Cong., 2d Sess. 56, note 5 (1996)).

> It shall be an unlawful employment practice for an employer to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin;. . . ."[133]

Religious Exemption

One exemption from Title VII that has important ramifications for tax-exempt religious organizations only is commonly called the "religious exemption" or "section 702 exemption." It states, "This subchapter shall not apply to . . . a religious corporation, association, educational institution, or society with respect to the employment of individuals of a particular religion to perform work connected with the carrying on by such corporation, association, educational institution, or society of its activities."[134] By limiting the scope of the act Congress clearly intended for religious institutions to have the right to discriminate on the basis of religion. However they are *not* able to discriminate on the basis of sex, race, national origin, age, or color. In one of the early landmark cases discussing the religious exemption the 5th Circuit stated,

> The language and the legislative history of section 702 compel the conclusion that Congress did *not* intend that a religious organization be exempted from liability for discriminating against its employees on the basis of race, color, sex or national origin with respect to their compensation, terms, conditions or privileges of employment.[135]

The scope of section 702 was not always so broad. When originally enacted, only the *religious activities* of the exempted organizations were not subject to the section 701 guidance.[136] In other words, at its inception, Title VII only allowed religious

[133] Title VII of the Civil Rights Act of 1964, § 703, 42 U.S.C.A. § 2000e-2(a)(1) (West 2008).
[134] Title VII of the Civil Rights Act of 1964, § 702, 42 U.S.C.A. § 2000e-1(a)(1) (West 2008).
[135] McClure v. The Salvation Army, 460 F.2d 553, 558 (5th Cir. 1972) (emphasis added).
[136] Civil Rights Act of 1964, Pub. L. No. 88-352, § 702, 78 Stat. 241, 255 (1964).

organizations to discriminate on the basis of religion in their *religious* activities.[137] Following the landmark case of *McClure v. The Salvation Army* in 1972, Congress amended the religious exemption to include *all* activities of religious organizations, not just *religious* ones.[138] This amendment was affirmed by the Supreme Court in 1987 in another landmark case, *Amos*.[139] The court in *Amos* held "[T]he 702 exemption was constitutional as applied to the secular nonprofit activity of a church."[140] So as it stands today, in hiring employees for *any* activity they support, a religious organization *can* discriminate on the basis of religion.

Ministerial Exception

After *McClure*, the religious exemption led to another change in employment matters for religious organizations; the ministerial exception. In *McClure* the plaintiff, Billie McClure, was a commissioned officer (minister) with the Salvation Army.[141] Her officer status was terminated, and she sued alleging the Salvation Army had discriminated against her as an employee.[142] Specifically, she alleged she received less salary and fewer benefits than her male counterparts, and she was fired because of complaints regarding these acts to superior officers and the Equal Employment

[137] The statute originally read, "This title shall not apply to an employer with respect to . . . a religious corporation, association, or society with respect to the employment of individuals of a particular religion to perform work connected with the carrying on by such corporation, association, or society of its *religious* activities . . ." (emphasis added).
[138] Laura L. Coon, Note, *Employment Discrimination by Religious Institutions: Limiting the Sanctuary of the Constitutional Ministerial Exception to Religion-Based Employment Decisions*, 54 VAND. L. REV. 481, 487 (2001). *Accord,* Pub. L No. 92-261, § 702, 86 Stat. 103,104; note 58.
[139] Corp. of the Presiding Bishop of the Church of Jesus Christ of Latter-Day Saints v. Amos, 483 U.S. 327. (holding a religious organization has the right to discriminate on the basis of religion in hiring employees for any type of activity sponsored by the organization.) *See also,* Coon, *supra* note 139 at 496.
[140] Thomas M. Messner, Note, *Can Parachurch Organizations Hire and Fire On the Basis of Religion Without Violating Title VII?*, 17 U. FLA. J.L. & PUB. POL'Y 63, 81 (2006) (quoting Amos at 330).
[141] *See* McClure v. The Salvation Army, 460 F.2d at 555.
[142] *Id.*

Opportunity Commission (EEOC).[143] The Salvation Army argued that since it was a religious organization, it was *not* subject to the provisions of Title VII because of the Section 702 exemption;[144] therefore, they could discriminate against the Plaintiff. The court disagreed with this argument because Mrs. McClure's claim was based on *sex* discrimination, not *religious* discrimination.

The Court could have ended its discussion here, but because the statutory exemption did not apply it considered "whether applying Title VII to the ministerial employment relationship in this case was constitutional."[145] The Court posed the question, "Does the application of the provisions of Title VII to the relationship between The Salvation Army and Mrs. McClure (a church and its minister) violate either of the Religion Clauses of the First Amendment?[146]

To begin its analysis, the court quickly conceded that the United States Supreme Court has recognized a "wall of protection" between church and state because of the First Amendment.[147] Its analysis focused on the vital relationship between the church and the minister; the court referred to it as the "life blood" of the church.[148] The minister is the "chief instrument" the church uses to achieve its mission, and issues affecting this relationship must be seen "as of prime ecclestical concern."[149]

As early as 1871 the Supreme Court saw matters of church leadership and administration as "beyond the purview of civil authorities."[150] This thought remained

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[143] *Id*.
[144] *Id*. at 558.
[145] Coon, *supra* note 138, at 500.
[146] *McClure* 460 F.2d at 558. The Religion Clauses in the First Amendment are the Free Exercise Clause and the Establishment Clause.
[147] *Id*.
[148] *Id*.
[149] *Id*. at 559.
[150] Id. (citing Watson v. Jones 80 U.S. (13 Wall) 679, 20 L. Ed. 666, (1871)).

almost eighty years later in the Supreme Courts decision of *Kedroff v. St. Nicholas Cathedral.* Finding a state law to be unconstitutional, the court held, "[L]egislation that regulates church administration, the operation of the churches, [or] the appointment of clergy * * * prohibits the free exercise of religion."[151] In deciding *McClure*, the Supreme Court relied on prior decisions by holding the application of Title VII to the relationship between a church and its minister would encroach on "an area of religious freedom which it is forbidden to enter by the principles of the Free Exercise Clause of the First Amendment."[152]

Therefore, after *McClure*, religious organizations that find themselves being sued under Title VII have two lines of defense. They can rely on the section 702 Exemption and safely claim they are free to discriminate on the basis of religion when hiring for any activity. Alternatively, if one of their ministers is suing them for sex, race, age, or national origin discrimination, the religious organization can rely on the ministerial exception which "provides religious organizations with immunity from Title VII claims by ministerial employees."[153]

Minister Defined

Thus, the question is presented, "Who qualifies as a minister?" The courts have addressed this issue in a number of cases. Two of those have provided a couple of important principles that religious organizations and courts can use to determine whether the organization's case is open to judicial review. The first principle recognizes that a court does not have to automatically accept that someone is a minister just because a

[151] *Id*. (citing Kreshik v. St. Nicholas Cathedral, 363 U.S. 190, 80 S. Ct. 1037, 4 L. Ed. 2d 1140 (1960)) (editing in original).
[152] *Id*. at 560.
[153] Coon, *supra* note 138, at 503.

church has said that he or she is one. Instead, courts are free to fully examine the duties of the job and decide if that particular position is vital to the organization's mission. If it is, then the position is "off limits" to the courts.[154] The second principle says if a court recognizes that a particular position does not qualify for the ministerial exception, the church can argue that application of Title VII (section 701), "would impermissibly entangle church and state if the ensuing church/state relationship would be substantial or adjudication would impermissibly burden the exercise of religious beliefs."[155]

With these principles in mind, the courts will use the "primary duties of the plaintiff" test to determine if a particular position is held by a "minister." "[I]f the employee's primary duties consist of teaching, spreading the faith, church governance, supervision of a religious order, or supervision or participation in religious ritual and worship" then the ministerial exception should apply.[156] The *Southwestern Baptist* court simplified this test by noting a church needed to show the employee was/is an "intermediary" between the church and the congregation.[157]

Once a church argues that the plaintiff is a "minister," which allows the church to discriminate on the basis of age, sex, national origin, or race, the court will evaluate whether the individual "attended to the religious needs of the faithful" or "instructed

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[154] Coon, *supra* note 138, at 512 (citing Equal Employment Opportunity Comm'n v. Sw. Baptist Theological Seminary, 651 F.2d 277, 282 (5th Cir. 1981)).
[155] *Id*. (citing Sw. Baptist at 284-86).
[156] *Id*. (citing Rayburn v. Gen. Conference of Seventh-Day Adventists, 772 F.2d 1164, 1168 (4th Cir. 1985)).
[157] Equal Employment Opportunity Comm'n v. Sw. Baptist Theological Seminary 651 F.2d 277, 283 (5th Circuit 1981) (holding that seminary faculty members were intermediaries and therefore ministers because they instructed the seminary students in religious doctrine and only religious orientated courses were taught. The court also found that support staff and part time employees (secretaries other administrative personnel) were not ministers because they did not perform job functions considered eccleastical or religious.)

students in the whole of religious doctrine."[158] If the court finds the individual did *not* meet the needs of the congregation nor instruct students in religious doctrine, then the church can *not* rely on the ministerial exception as a defense because the person is/was not a minister.

However, as with many legal tests, there is some room for flexibility. Even though the "primary duties of the plaintiff" test is commonly used, it has also been modified in some situations. For example, some courts have agreed with churches arguing a musician is a minister because she performs duties that are "important to the spiritual and pastoral mission of the church."[159] Therefore, churches have been given freedom to protect themselves from judicial scrutiny and Title VII restraints by creatively arguing an individual is a minister.

So, how does all of this play out for a religious organization? Consider the following example. Suppose First Church is looking for an individual to take care of the facilities. According to section 702 they are allowed to make their decision in part on the religious affiliation of the applicants. So if an agnostic applies, First Church can safely choose not to hire them because they do not have the same religious beliefs as the church. But suppose there is one candidate who is clearly better qualified than the rest, and it just so happens that candidate, Janice, is a female. First Church can not rely the statutory exemption (section 702) and decide they will not hire her just because she is a woman; this would be sex discrimination and section 702 (the religious exemption) does not allow this.

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[158] Coon, *supra* note 138, at 514. (citing Sw. Baptist at 283-85 and EEOC v. Miss. Coll. 626 F.2d 477, 485 (5th Cir. 1980)).
[159] *Id*. at 517. (citing Assemany v. Archdiocese of Detroit, 434 N.W.2d 233, 238 (Mich. Ct. App. 1988)).

Suppose several years after hiring Janice, she sues First Church, alleging she has been subject to sexual discrimination by another staff member. First Church can *not* rely on the ministerial exception and argue they are exempt from Janice's Title VII claim. Because Janice is not a minister she is free to bring this case and it will not be dismissed under the ministerial exception doctrine. On the other hand, if Janice has worked her way up from her simple janitorial position to a "Minister of Facilities" then the court will have to consider whether this new position involved attending to the religious needs of the faithful. Janice can argue that her team is responsible for maintaining an aesthetically pleasing and safe environment so church members can enjoy and fully participate in church assemblies and functions. The jury will have to determine if Janice is a "minister" and if First Church can rely on the ministerial exception. If the jury finds she is a minister, then First Church can have the case dismissed because the Free Exercise and Establishment Clauses of the First Amendment. On the other hand, if the jury finds she is not a minister then the case will proceed.

Conclusion

There is no valid reason to not assume that nonprofit organizations growth and impact on this nation's and the world's economies, the number of people employed by them, and the amount of money given to them will only increase. Therefore, those who deal with them are well advised to be familiar with the laws that govern them. The topics in this article are just the "tip of the iceberg;" there is considerably more information available and some is presented in much greater detail. This article simply expounds on three main areas of law that an average nonprofit employee or director can benefit from.