

# nonprofit Navigator

## “Pro-Majority” Organization Held to be Neither Charitable Nor Educational

**N**onprofits seeking to secure IRS recognition as 501(c)(3) organizations now have an example of how not to go about proving their activities are worthy of tax exemption. In a recent decision, the United States Tax Court upheld an IRS determination that the Nationalist Foundation, an organization dedicated to becoming the legal and educational arm of “rightist and pro-majority Americans,” failed to prove that it engaged in charitable and/or educational activities. The decision highlights the legal standard used by the IRS to determine exemption under Section 501(c)(3).

The Nationalist Foundation, a Mississippi nonprofit organization, was created to counteract the work of organizations that it views as “leftist threats to our liberties,” including the NAACP Legal Defense Fund and the American Civil Liberties Union. Pro-white, anti-minority, and anti-gay, the Nationalist Foundation applied for recognition as a 501(c)(3) organization in 1996. The Foundation shares goals and staff members with the Nationalist Movement, another Mississippi nonprofit which was previously denied (c)(3) status [see *Tax Monthly* 6/94, 12/94]. In its tax exemption

application, the Nationalist Foundation claimed to engage in charitable and educational activities, including conducting forums on Constitutional issues (especially those concerning First Amendment rights), initiating litigation to “protect civil and constitutional rights,” and conducting Internet-based seminars on “teaching skills for effective social action” without violating laws on hate crimes, housing discrimination, and other forms of harassment.

*Charities should not distort facts.*

The Foundation appealed to the Tax Court after the IRS denied it tax exemption, arguing that its activities were charitable and educational because they promoted free speech and the exchange of ideas and information. It especially questioned the constitutionality of IRS Revenue Procedure 86-43, which delineates the methodology used by the IRS in determining whether an organization’s activities qualify as “educational.”

Revenue Procedure 86-43 sets forth the IRS’ methodology test, which is used when an

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Nonprofit Navigator is published monthly by the Washington, D.C. law firm of Harmon, Curran, Spielberg & Eisenberg, LLP. Subscription rates are \$115 for one year and \$198 for two years for subscriptions sent within the United States. Special rates are available on request for multiple subscriptions sent to the same address and for outside the U.S. All rates subject to change without notice. Subscription requests and address changes may be addressed to:

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# Employment Matters

## Can I Get a Witness?

### Employees Can Request Representatives in Disciplinary Meetings

Nonprofits may have thought they could safely ignore most of what the National Labor Relations Board has to say. After all, their workforces are typically not union shops and the NLRB generally concerns itself only with unionization issues. But a recent NLRB decision has injected the agency into one of the least pleasant of employer-employee interactions: the disciplinary meeting. Under the NLRB's decision *Epilepsy Foundation of Northeast Ohio*, a non-union employee is entitled to be represented by a co-worker when being questioned by her employer in what she reasonably believes to be a disciplinary investigation. Such a representative's role is to "clarify the facts or suggest other employees who may have knowledge of them."

This right, called the Weingarten Doctrine by labor and employment specialists, grew out of a Supreme Court case allowing workers to have a union representative present in a disciplinary meeting. While this is far from a right to have counsel present in such meetings—a representative may not object to questions or advise her co-worker not to answer—it has important ramifications for employer investigations of employee conduct.

Some commentators have noted that the extension of the Weingarten right poses particular problems, especially sexual harassment cases. If an employer meets with an employee accused of sexual harassment, and the employee demands a co-worker representative, the risk of retaliation against the alleged victim may increase. Further, maintaining confidentiality becomes progressively more difficult as the number of people in the know increases. Other concerns ensue if two employees are collectively engaged in wrongdoing. If

each employee requests the other's presence in an investigative meeting, they will be able to easily coordinate their stories. On the other hand, the right to representation can prevent abusive investigatory tactics such as coerced confessions, and, if used properly by both sides to a dispute, can lead to a fuller explanation of the facts.

There are nonetheless some important employer rights under the Weingarten Doctrine. Employers are not required to inform employees of their right to request a representative. Further, supervisory and managerial employees are not covered. While the NLRB's definition of these two categories is not altogether clear, employers can generally assume that employees with actual or effective authority to hire, fire or discipline other employees, or who formulate or effectuate management policy are excluded. Finally, an employer's investigation cannot be unreasonably delayed while the employee chooses a representative. The NLRB and the courts have acknowledged that an employer can justifiably require that the employee's representative be an available on-site co-worker. An employee cannot demand a colleague on a six-month sabbatical as her representative in order to delay proceedings.

The practical real-world ramifications of the extension of the Weingarten Doctrine are somewhat unclear. An egregious violation of the right can lead to a NLRB finding of unfair labor practices resulting in a cease and desist order. In extreme cases resulting in the employee's termination, the NLRB may demand reinstatement and back pay. Regardless of this particular area, like all employers, nonprofits need to keep in mind their obligations under local, state and national labor law.

## Pro-Majority, cont.

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organization's educational activities are in question. The test provides that the IRS will consider the methods used by an organization in advocating its position, rather than the position itself, as the standard for determining whether an organization's stated purposes may be considered "educational." The Revenue Procedure indicates that presenting viewpoints or positions unsupported by facts or supported by distorted or untrue statements is indicative of non-educational advocacy. So are using "inflammatory and disparaging terms" and expressing conclusions "on the basis of strong emotional feelings."

*The organization was created to counter "leftist threats."*

Some of the Nationalist Foundation materials that appeared in the Tax Court case contained statements with no basis in fact or statements that exaggerated or distorted the truth. One solicitation letter stated that "In New Hampshire, avowed homosexuals advertised that they would attack patriots calling for abolishing the [Martin Luther King, Jr.] Holiday" when in reality members of the National Peoples Campaign did no more than shadow Nationalist Foundation members outside the State House to protest their views. The court noted that the administrative record of the Nationalist Foundation's activities was vague and inconsistent: although the Foundation's website listed links to articles such as "Constitutional Protection," "Nationalist Ideology," and "Using the First Amendment as Democracy's Shield and Sword," the Foundation refused to place these articles in the record. The Foundation also attempted to withdraw much of the record of its activities

from the case, implying that these activities did not meet the requirements of Section 501(c)(3).

The court also evaluated whether the Foundation qualified as "charitable." It held that the Foundation's stated goals and activities, not simply its methods, "serve the purpose of increasing social activism of pro-majority and rightist beliefs and are antithetical to . . . examples of charitable activities" as found in the Treasury Regulations. These examples include eliminating prejudice and discrimination and lessening neighborhood tension.

The Tax Court's ruling emphasizes that the burden of proving charitable and educational activities falls on the entity seeking tax-exempt status. It is not enough for an organization to state that it engages in charitable and educational activities. While it is perfectly appropriate for a charity to advocate a position, it may not simply do so without providing a factual foundation upon which that position is based. And while the charity need not present both sides of an issue, it is important to provide a reasoned analysis that enables others to understand the issue and come to their own conclusions.

### "Educational" Purposes: Making The Case

#### Do:

- Advocate a position
- Provide a factual basis for your position
- Make your reasoning clear
- Be accurate
- Credit your sources of information

#### Don't:

- Distort facts
- Use inflammatory rhetoric

## 527 Rules

### Electronic Filing Promised, But No Immediate Paperwork Relief

The IRS has issued the final version of Revenue Ruling 2000-49, describing the implementation of the new legislation requiring Section 527 political organizations to register with the IRS, provide periodic reports of certain contributions and expenditures, and file Form 990.

The Service conceded that the 527 disclosure rules imposed a significant administrative burden on state and local political action committees which already comply with state and local registration and reporting requirements, but indicated there was little the Service could do for them. There is a bill in the House of Representatives to exempt some state and local political organizations from filing if they already file with a state regulatory body.

Further, according to the release issued with

the ruling, the Service is working on creating an electronic filing system for Form 8872, the periodic reports. The IRS refrained from promising an implementation date.

Because copies of Forms 8871 and 8872 filed with the Service are available at its website, at <http://www.irs.gov/polorgs>, the ruling allows organizations to consider these documents to be “widely available” once filed. This means that organizations will not have to provide copies upon request. Nonetheless, organizations must continue to make these forms available for public inspection during regular business hours at their principal office, and any regional office with more than three employees, a rule mirroring the public inspection rules for 501(c)(3)s and (c)(4)s [NN, 5/99 p. 2].

### UBIT Update

The IRS recently released an updated Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*. The publication discusses the application and calculation of UBIT, the types of organizations subject to UBIT, and the transactions

triggering the tax. It also outlines recent changes in UBIT rules.

Exempt organizations with any unrelated business income are advised to download the publication from <http://ftp.fedworld.gov/pub/irs-pdf/p598.pdf> or <http://www.irs.gov>.

### Speedy Service

Of particular interest to new organizations is a new Tax Exempt/Government Entities (the recently reorganized division with responsibility for exempt organizations) call center at 1-877-829-5500 between 8:00 a.m. to 9:30 p.m. Eastern.

IRS officials have promised that by calling this number, organizations can learn the status of a tax exemption application, get

questions answered on a variety of EO issues, and receive some assistance in getting speedier assignments of employer identification numbers. The latter feature is particularly important for 527s that need EINs to file Form 8871 within 24 hours of creation.

A test drive at lunchtime on a Thursday got a response in just one ring, after a remarkably short voice mail maze.

## New York Court Sides with Donors, Against Charity

In September, the Appellate Division of the Supreme Court of New York affirmed a lower court's 1999 ruling that the New York Community Trust should not have diverted grant funds that the original donors had earmarked for the Community Service Society [NN, 12/99, p. 6]. Because the Trust redirected the funds 29 years ago, however, the Appellate Division reversed the damage award, holding that the six-year statute of limitations had long expired.

*The Society would have had to cease carrying out its stated purpose for a legitimate finding of undesirability.*

As we noted last year, the decision is at odds with the IRS's oft-stated position that extensive donor control over the use of grants to community foundations is problematic.

Community foundations, of which the New York Community Trust is the nation's largest, are essentially umbrella charities that manage separate funds from different donors. Those funds are then distributed to donor-specified charities or for charitable purposes.

IRS regulations require that the community foundation have ultimate control over how the money in such donor-designated funds is spent. While donors may still make recommendations, the community foundation must be the final decision-maker. In contrast, the New York Community Trust accepted donor-designated gifts subject only to a variance power, which allowed it to redirect funds if the circumstances had so changed from the time of the donor's original bequest that continued earmarked funding was "unnecessary, undesirable, impracticable or impossible."

At issue in this case are bequests to the Trust from the 1920s and 30s earmarked for the Community Service Society. Periodic distributions occurred as directed until the 1970s, when the Trust examined the newly enacted rules on community foundations and simultaneously the Society redirected its efforts from direct aid to the poor in New York City to working with other like-minded organizations in a support capacity. In 1971, the Trust reviewed the Society's operations and concluded that circumstances had changed, rendering literal compliance with the terms of the original bequest undesirable. The Trust then converted the funds into a semi-directed grant for the improvement of health and welfare in New York City. The Society continued to receive grants from the Trust on an application-by-application basis.

The Appellate Division concurred with the lower court's ruling that in the absence of guidelines, the decision to redirect funds should "reflect a policy that maximizes the utility of community foundations to provide donors with the option of making their own choices of beneficiaries, while preserving the efficacy of their gifts should later circumstances undermine that choice." The New York Community Trust failed that standard when it redirected the funds because its decision was not "grounded in a change of circumstance that negatively affect[ed] the designated charity to such a degree that it would be likely to prompt a donor of the fund to redirect it." The court suggested that the designated charity would have had to cease carrying out its stated purpose for a legitimate finding of undesirability to be made.

In its defense, the Trust claimed it was wary of a provision in the Tax Reform Act of

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# Employment Matters

## Combating Employee Theft Some Tips on Identifying and Preventing Fraud

*The Nonprofit Navigator periodically features articles by experts in the nonprofit community. The following article is adapted and excerpted in part from the Nonprofit Controller Manual by Craig Stevens, a CPA with the Rockville, MD firm of Aronson, Fetridge & Weigle.*

Some experts estimate that employees steal as much as \$40 billion annually from their employers. Unfortunately, nonprofit organizations are not immune to employee theft. In recent years some high profile cases of fraud perpetrated against nonprofit organizations have made headlines, but fraud occurs on a smaller scale across the country on a regular basis.

Developing strong internal control procedures is the best line of defense against internal theft. The most important control is not allowing any one employee to have a high level of authority without adequate oversight. Unfortunately, as case after case shows, the persons most likely to defraud employers are long-term, trusted employees who are so familiar with the systems in place that they are able to recognize and take advantage of weaknesses in control.

The most common types of employee fraud schemes involve the manipulation of cash, accounts receivable, inventory, purchasing functions, payroll, and personal expenses. Bank cash deposits and petty cash can be misappropriated through a variety of means, from skimming cash before it is entered into the accounting system to the unauthorized reproduction of company checks. Accounts receivable are vulnerable to manipulation, particularly when donations are received in cash. Fictitious invoices and vendor kickbacks can taint the purchasing system, while “ghost” employees and overstated overtime and expense reimbursement are common targets of fraud in the payroll system.

In order to effectively combat fraud, top management must, first and foremost, be

constantly aware of the potential for fraud, be committed to integrity in the organization, and demonstrate strict intolerance for fraudulent acts. Boards of Directors should form a separate audit committee to meet with their organizations’ external auditors and discuss internal control issues. If possible, an independent audit, including an internal control review, should be conducted annually. Since fraud often occurs as a result of situational pressures, such as gambling or divorce, take special precautions when financial personnel are facing these issues.

Timely financial reporting and reconciliation of bank accounts and important ledgers should be part of the routine function of the organization. Rigorous budgeting for the entire organization should take place, along with frequent comparisons of budgeted amounts with actual results. Fidelity bond coverage of employees, as well as a policy of providing incentives to report unusual behavior by other employees, are effective means of lowering risk and preventing fraudulent acts.

### Steps Organizations Can Take to Lessen Fraud

There are a number of simple steps that organizations can take that greatly lessen the chance of most common types of fraud from occurring. They include:

1. Designate a person not responsible for handling cash to receive unopened bank statements and perform bank reconciliation.
2. Review vendor invoices when checks are signed. In addition, use signature stamps only when authorized signers are truly

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## Combating Theft, cont.

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### Steps Organizations Can Take to Lessen Fraud, cont.

unavailable and immediate payment is required.

3. Conduct surprise cash counts of petty cash funds.
4. Follow up on customer, donor, or member complaints about failure to receive credit for payments or donations.
5. Instruct someone other than the person who prepares journal entries to review them.
6. Safeguard blank check stocks.
7. Implement a positive pay protection system, if feasible, whereby the bank is notified of checks (with date, number, payee and amount) as they are written in a financial accounting software program, and the bank will not honor any check for which it has not received notification.
8. Make frequent cash deposits, daily if possible.
9. Segregate the duties of those individuals responsible for cash receipts, bank deposits, bank reconciliations, and disbursements.
10. Rotate assignments and enforce a mandatory vacation policy.
11. Implement inventory controls, including regular physical counts and analytical

review of trends in sales and costs.

12. Segregate payroll duties between those responsible for payroll preparation, payroll disbursement (into payroll and withholding tax accounts), payroll distributions, and payroll bank reconciliation. Using an outside payroll service is also a good control.
13. Periodically review payroll records to detect more than one employee with the same address or social security number and employees with no withholdings.
14. Review expense reimbursement requests carefully.
15. Review income from membership, convention receipts, educational conferences and so forth, reconciling the number of members and calculating the approximate revenue based on attendance and fees compared to the general ledger income figures. Each event should be separately budgeted and results reviewed against actual results for each event.
16. Have accounts receivable and donations sent directly to a bank "lock box."
17. In the event employee fraud does occur, make sure your insurance policy covers employee dishonesty.

Ongoing monitoring of the internal control system is necessary as control systems change over time. In addition, consult with external auditors to review your internal controls and help you develop appropriate systems for your

organization. Having an independent audit is a good monitoring activity for many nonprofits as material control weaknesses should be noted in the auditor's management letter.

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## New York Court, cont.

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1969 raising concerns about donor control and implied that excessive donor control would put a community foundation's tax exemption at risk. By exercising its variance power, the Trust could convert some of its donor-restricted funds into discretionary funds. The court was skeptical of this argument, suggesting perhaps that the Trust has a preference for unrestricted funds over which it could exercise control. The

court observed that the IRS had never investigated the level of donor control at the Trust, nor had it established percentage limitations for donor-restricted funds as a percentage of a community foundation's total assets.

Further appeals of this decision are expected. Meanwhile, community foundations should proceed cautiously when deviating from agreements with donors.

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Paul joined Harmon, Curran, Spielberg & Eisenberg in October 2000. While attending law school, Paul served as a law clerk in the Office of General Counsel of the American Federation of State, County and Municipal Employees. He also worked as a law clerk in the legal departments of Gore 2000 and Clinton/Gore '96, where much of his effort was devoted to compliance with Federal election law. In 1997 and 1998, Paul served as a legal intern on the Minority Staff of the U.S. Senate Governmental Affairs Committee's Special Investigation of illegal or improper activities in connection with the 1996 Federal election campaigns. Prior to moving to Washington, DC to attend law school, Paul worked over five years as a commercial insurance underwriter for Liberty Mutual Insurance Group outside of Boston, Massachusetts.