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COUNSELLORS AT LAW

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NONPROFIT ORGANIZATION REPORT – WINTER 2015

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A Potpourri of Cases and Developments

IRS Takes God's Side in Dispute with Atheist Nonprofit. We represent several religious nonprofits, and for that reason we took interest in a recent court decision in which a nonprofit atheist organization tried unsuccessfully to manipulate the tax law to strike a blow against nonprofit religious organizations – only to outsmart itself in the process.

The Freedom From Religion Foundation (FFRF) is a Section 501(c)(3) organization based in Wisconsin, and its mission is to advance non-theism or "freethought." In 2012 FFRF sued the IRS in Federal Court to challenge the "parsonage allowance," a tax code provision which permits religious nonprofits to pay a non-taxable housing allowance to "ministers of the gospel."

FFRF set itself up to bring the case by having its board vote to pay a "housing allowance" to its husband and wife co-presidents. The FFRF and the co-presidents then sued the IRS saying they were injured by the different tax treatment they were forced to endure (paying tax on their "housing allowance" while ministers of the gospel do not), and that this "injury" was caused by the unconstitutional favoritism the parsonage allowance affords religious nonprofits.[1]

The IRS defended the suit very creatively. First, it asked – who's to say that FFRF could not take advantage of the "parsonage allowance?" FFRF and the co-presidents never tried to claim tax free treatment for the "housing allowance" on their tax returns; the IRS pointed out that until they tried (and were denied by the IRS itself in an audit) the damages alleged were merely speculative.

Second, the IRS noted that under existing tax law the "ministers of the gospel" language has been interpreted as a non-sectarian term that means *glad tidings or a message, teaching, doctrine, or course of action having certain efficacy or validity*, and that in several cases the courts have recognized secular humanism as a religious practice. In other words, under the tax law atheism qualifies as a form of religion such that if FFRF and its co-presidents really wanted equal tax treatment for their "housing allowance" they could have claimed it on their tax returns. The Seventh Circuit Court of Appeals dismissed the suit.

Candidly, the results of this case were easy to anticipate, and we suspect that the suit was brought more to garner publicity for FFRF than with the expectation of a victory. We also doubt that FFRF will try to claim the benefit of the "parsonage allowance" simply because doing so would require it to treat "atheism" as a form of religion. This would, in an almost comical way, undermine its many other legal cases (FFRF is very litigious and uses litigation and threats of litigation all over the country to advance its mission) because it would give those cases the appearance of a religious tug of war in which one

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[1] The Constitutional issue raised by FFRF is the separation of church and state principle. However, we are interested in the case because of the way FFRF manufactured a basis for its claim by creating its "housing allowance" out of whole cloth solely (we surmise) to hassle nonprofits with contrary missions.

religion (atheism) was attempting to use the courts to restrain the functions of other (more traditional) forms of religion. Nevertheless, only God knows what FFRF will try next.

Legal "Fee Shifting" Provision in Nonprofit By-laws. On more than a few occasions we have represented nonprofits involved in internal disputes – ones in which directors, members, and/or the nonprofit itself end up in a clash and in the courts.[2] These are never pleasant assignments because of their high stress levels, and the legal fees and expenses incurred would be better spent on the mission.

With these thoughts in mind, we read with interest a recent decision of the Delaware Supreme Court upholding the legality of "fee shifting" provisions in the By-laws of a nonprofit membership corporation formed under the laws of that state. The provision stated that in the event a member brings a claim against the organization and/or other members, and if the member bringing the suit fails to achieve in substance and amount the full remedy sought, then the member who brought the claim must reimburse the organization and other members it sued for legal fees and costs incurred in defending the claim.

The court acknowledged that under the so-called "American Rule" parties to litigation must pay their own legal fees (win or lose), unless there is a specific statute or contract term that provides otherwise. In the United Kingdom the "English Rule" generally requires the "loser" to pay the winner's legal fees. The issue before the court was whether the By-law provision was a lawful way to (in essence) adopt the English Rule. The court concluded that the provision was generally lawful, but did caution that it might not be enforced in "bad faith" circumstances, such as adding the provision to the By-laws immediately prior to the filing of a suit that was foreseeable.

The legal enforceability of these provisions (actually having a court order that fees be reimbursed after the litigation is over) will depend on how carefully they are drafted, the nature of the claims, the law of the state of incorporation, whether the claim is brought by a member, a director, or even an affiliated organization, and other factors.[3]

However, we believe these provisions could have great value even if their enforceability is never tested (after a litigation is over) because their mere presence in the By-laws may change the risk calculus for the people (and their lawyers) contemplating whether to bring the claim in the first place. If you know that the ultimate downside risk of losing your claim is not only your own lawyer's fees, but possibly (if the fee shifting provision is enforced) the fees your opponents incur, you may be much less inclined to bring the claim. In other words, a provision of this type should in any event reduce the likelihood of litigation in the future and may encourage the persons involved to find other means to resolve a claim

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[2] The cases have involved, for example, a struggle for control (board seats), an attempt by a church which was the sole member of a low income housing corporation to supplant the housing corporation board and take over the housing property, and members and a board minority challenging the authority of the board majority to take certain actions.

[3] The point to keep in mind is that the enforceability of a fee shifting provision most likely will be an issue only ***after*** the suit is over and there is a winner. The winner would then make a demand or bring a separate suit seeking recovery of fees under the provision, and the loser could then argue that the provision is not enforceable under the law.

or a dispute – such as mediation or arbitration (referred to as "Alternative Dispute Resolution" methods).[4]

We will continue to think about By-law provisions of this type, and before reaching any conclusions will examine the dust storm the Delaware court ruling kicked up among interest groups which do not want corporate By-laws (at least in the for-profit corporate context) to be used for these purposes.

And a Case in Point About the Potential Utility of Fee Shifting Provisions. As we were researching the fee shifting issue discussed above, we read a recent (2014) California case in which a physician member of the American Association of Physician Specialists sued members of the board of directors and the Association alleging, in part, that the decision to terminate her membership in the Association was a breach of the fiduciary duties owed to her (as a member) by both board members and the Association itself.

The court dismissed the "fiduciary duty" claim because the member (really her lawyers) failed to make sufficient allegations in the suit to support the claim that the nonprofit and the board members owed fiduciary level duties of care and loyalty to members of the Association (the relationship is really contractual and brings with it a lesser level of responsibility).

The question, of course, is whether the fiduciary duty claim (or other claims in the suit) would have been brought if the Association had a fee-shifting provision in its By-laws – such that the member's downside risk in the event of a loss would include having to pay both her legal fees and the legal fees incurred by the directors and the Association. Perhaps both sides of this claim might have been better off (less time and money) if there was a mandatory Alternative Dispute Resolution provision (mediation or arbitration) in the By-laws.

IRS Regulation of Nonprofit Governance Takes a Blow. The IRS's attempts to intervene in nonprofit governance are very controversial, and a recent court case gives an additional reason to believe that the IRS will eventually be forced to retreat and keep its focus on federal tax law. Let us frame the issue with some history and an example of confusion caused by the IRS's intervention, and then look at the court case.

The IRS's foray into governance began when it inserted Part VI into the annual tax return (Form 990) in 2008 – which asks several board/management governance questions in a basic "yes or no" format. The principal criticisms of this effort were that IRS personnel were not adequately trained for this task; that governance questions are a matter of state law (each of the fifty states has its own rules);[5] and, most importantly, Congress did not (by statute) give the IRS the authority to undertake this effort.

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[4] As we were writing this edition it occurred to us that it might be useful for nonprofits to include a By-law provision requiring that intra-organization claims be submitted to mediation (which is not binding but is often effective) and/or arbitration (binding but heard by a hired professional instead of a judge) for resolution instead of the courts. While lawyers' opinions differ on the efficacy of these Alternative Dispute Resolution (ADR) methods, they have certain advantages over civil litigation that may be particularly helpful when nonprofits are involved: they are generally less expensive and, unlike the courts, are private and not open to public. Note that an ADR provision would determine how the claim is resolved, which is different from the fee shifting provision which would, as stated above, come into play only afterwards. Having said this, an ADR provision could give an arbitrator the power to award or allocate fees as part of a final decision, or could itself direct how those fees are to be allocated.

[5] Federal nonprofit tax law, by contrast, applies uniformly in all 50 states.

Here is an example of the confusion created by Part VI of Form 990. Question 15 asks ("yes or no") if the nonprofit's process for determining the compensation of the Executive Director includes "a review and approval by independent persons, comparability data, and contemporaneous substantiation…." The phraseology of the question, and fact that the nonprofit must answer "yes or no" implies (not that subtly) that the law requires a "review and approval by independent persons" when setting compensation, when in fact the law does not do so. The law only requires that the Executive Director not be overpaid – and the "review and approval" mechanism is something that can be followed (or not) to create a presumption of reasonableness as to the compensation. The risk of confusion is not hypothetical – in 2014 we disposed of a whistleblower complaint in which a nonprofit answered "no" to this question and the whistleblower wrote to the board claiming that the nonprofit was, therefore, operating unlawfully.

The court case (decided last year) is *Ridgely v. Lew*. The Federal District Court concluded that the IRS did not have the legal authority to regulate the filing of ordinary refund claims by persons authorized to practice before the IRS. This follows a similar defeat earlier in 2014 *(Loving v. IRS)* in which the Federal Court of Appeals concluded that the IRS did not have the authority to regulate tax return preparers. These cases demonstrate that the courts are willing to hold the IRS's feet to the fire whenever it starts to operate outside of the authority delegated to it by Congress. It is reasonable to believe that the IRS's governance initiative will someday meet the same fate in the courts.

The Reid and Riege Nonprofit Organization Report is a quarterly publication of Reid and Riege, P.C. It is designed to provide nonprofit clients and others with a summary of state and federal legal developments which may be of interest or helpful to them.

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