



# Nonprofit Alert®


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

## 1. Nonprofit Overview

### 1.1 IRS Gears Up to Enforce New Intermediate Sanctions Law.

Speaking to tax and legal professionals last month, Marcus Owens, Chief of the IRS Exempt Organizations Division, said the IRS is directing considerable resources to enforcing intermediate sanctions against executives who profit from their "inside" positions at nonprofit organizations. The sanctions consist primarily of personal penalty taxes that reach as high as 200% of the value of any benefits an insider receives from a nonprofit. Organizations also stand to lose their tax-exempt status, but the intermediate sanctions law gives the IRS an alternative to such drastic punishment. Instead, it allows IRS officials to go after individuals who profit, rather than penalize an organization for their misdeeds. IRS officials recommend the following steps to help protect charities:

- set up an independent committee of non-compensated trustees to handle salary and benefits issues subject to the law; this committee should also compare salaries against independent compensation data available from trade organizations and other sources;
- adopt and implement a conflicts of interest policy that clearly states the parameters for transactions between an institution and its officials (if you already have such a policy, review it to make sure it covers all points noted in the new law); and
- carefully document the compensation-setting process to include everything from salary comparisons to performance evaluations.

 **Three Nonprofit Alert® Memos provide step-by-step strategies for managing these risks: NP9102-7, *Establishing Reasonable Compensation for Nonprofit Leaders* identifies primary guidelines for setting appropriate salaries; NP9608-1, *Avoiding the Snares of Intermediate Sanctions* outlines the new law; and NP9110-3, *Conflicts of Interest Policy and Resolution* includes a sample policy. See back page to order.**

**1.2 Donor's Can't Sue to Enforce Gift Conditions, Court Rules.** Donors may not bring suits against charities compelling them to honor conditions or limitations placed on charitable gifts, a five-judge panel of the Connecticut Supreme Court has ruled. Although the decision comes from a state court, it is being hailed nationwide because it represents the first test of the Uniform Management of Institutional Funds Act, which now applies in a majority of states and the District of Columbia. The act gives sole responsibility to state attorney generals for ensuring that charities

honor the terms or conditions of gifts. If a charity fails, then state attorney generals may sue to compel compliance, but donors have no legal right to bring such actions. The Connecticut case grew out of a dispute between the Carl Herzog Foundation and the University of Bridgeport when the foundation attempted to redirect part of a 1986 gift. The foundation gave \$250,000 to the university for nursing scholarships, but asked the university to pass the remaining funds to another charity when the nursing school closed in 1991. The case is being appealed. *Carl J. Herzog Foundation v. University of Bridgeport*, (Conn. Sup.Ct. 1997). (See related story at ¶7.1).

★ **The good news is that charities gain greater control over their finances. The bad news is some donors may be discouraged from giving if they see this law as denying them any legal recourse when contributions are misspent. However, the law may actually relieve donors of the legal burden and expense of enforcing gift restriction since the law further empowers state attorneys general to investigate and compel compliance with gift limitations.**



**For an overview of the issues charities should consider when accepting gifts with conditions, review NP9302-1, *Avoiding the Pitfalls of Donor-Designated Gifts*. See back page to order.**

**1.3 States Eye Internet As Potential Source of New Taxes.** With commercialism soaring on the Internet, some states are attempting to enforce sales taxes on both access to and sales made over this new medium. Some taxes may even apply to items that nonprofits offer from their web sites on the Internet. However, a bill recently passed by a House Subcommittee (H.R. 1054) puts a moratorium on Internet taxes until state and

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local officials can review how they impact future growth of the Internet and its related technologies.

★If your organization offers anything for sale over the Internet or plans to do so in the future, this sales tax issue is something to watch closely—even if your organization is otherwise exempt from sales taxes in your home state.

➡ Vertex, Inc., a software company, has compiled a free guide to state Internet taxes called the “Vertex CyberTax Channel.” Find it at: [www.vertexinc.com](http://www.vertexinc.com).

## 2. Liability & Risk Management

### 2.1 Employer's COBRA Notice Must Also Go to Spouse.

Employers may be liable for damages if they don't give notice to an employee's spouse, who is eligible for medical benefits under federal COBRA laws, the 6th Circuit has ruled. The case involved a terminated employee who inquired whether his medical insurance would continue for his wife, who had breast cancer. On at least two separate occasions by two different employer representatives, the employee received assurances that coverage would continue. However, the employee's wife discovered she was no longer insured several months later when she sought preapproval for a medical treatment. The court ruled that COBRA requires notice to beneficiaries (including spouses) that their health insurance may continue for up to 18 months, but notice to the employee alone does not suffice for notice to beneficiaries, the court said. The employer was obligated to provide additional notice to the spouse in this case. *McDowell v. Krawchison*, 1997 WL 573086 (6th Cir. 1997).

➡ **COBRA laws require strict compliance by all employers, including nonprofits. Make sure you understand all your responsibilities with NP9102-5, COBRA Group Health Insurance. See back page.**

**2.2 Court Upholds Nonprofit's FUTA Exemptions.** Laws that exempt religious organizations from paying state unemployment and federal FUTA taxes on their employees do not violate the Establishment Clause or equal protection guarantees of the Constitution, the First Circuit has ruled. The case involved an employee in Rhode Island who, after being fired from her job with the Salvation Army, applied for state unemployment benefits. The state said she was ineligible because she worked for a religious organization that was not required to pay the state's unemployment insurance. She then sued the state and the U.S. Department of Labor, asserting that the federal FUTA provisions were an indirect cause of her denial because they allow state exemptions for religious employers. The court ruled against the

employee finding the state exemptions under FUTA constitutional because they have secular legislative purposes.

★Among many purposes, the court said FUTA exemptions eliminate the need for government review of employment decisions based on religious rationales. They also improve federal and state administration of unemployment programs because they have the effect of excluding workers “whose employment patterns are irregular or whose wages are not easily accountable,” the court said. *Guadalupe Rajas v. Lawrence Fitch, et.al.*, No. 96-2328 (1st Cir., 1997).

## 3. Employees & Volunteers

**3.1 Majority of Employers Sued During Last Five Years.** A new study by the Society for Human Resource Management, a trade association, reports that nearly 60% of employers surveyed earlier this year have been hit with at least one employment-related lawsuit at some time during the last five years. Respondents in the survey indicated nearly half the suits involved discrimination claims. This tracks with national trends that show escalating numbers of discrimination suits and increasing settlement awards, as recorded by the EEOC.

➡ **Nonprofits are not immune from this costly trend. Guard your organization against such claims by understanding the state and federal discrimination laws that apply to your organization. See NP9312-1, Avoiding Employment Discrimination in the Nonprofit Organization. See back page to order.**

**3.2 Firing Pregnant Employee Upheld When Performance-Based.** Documented performance problems can justify dismissal of an employee in a protected class, the Fifth Circuit has ruled. The court's decision was based on substantial evidence of substandard performance that Bisco Industries, an electronics manufacturer, presented against a black female manager who was pregnant at the time of her discharge. The company fired her for failing to meet profit goals for two consecutive years. Before her dismissal, she was granted a 90-day probation with a break-even profit goal, but she failed to reach this reduced minimum. The company then fired her and five other sales managers for poor performance. The court said the company's action was justified in light of her work record. *Walton v. Bisco Industries*, 119 F.3d 368 (5th Cir. 1997).

★The company also proved that none of her supervisors knew she was pregnant at the time of her discharge. Well-documented personnel records, plus the probationary period, clearly helped the company win this case.

➡ **Does your organization keep such complete personnel files? Review NP102-2, Wisely Managing Employee Terminations, for 14 steps to take on the way to termination. See back page to order.**

## 4. Tax-Exempt News & Issues

**4.1 University's Designated Gift Program Passes IRS Scrutiny.** The IRS recently approved a university's fundraising campaign that solicited donations designated for the restoration of particular fraternity houses on campus. Donors were asked to

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mark their contributions for specific fraternities, but the university only said it would “attempt” to honor those designations. The university kept full control over all donations. Fundraising literature made this clear to donors. The IRS said the university did not act as a conduit for gifts to the fraternities. Instead, it rightfully accepted designated gifts and was free to use the gifts according to its stated policies. IRS LTR 9733015.

★ **Designated gift programs attract many well-meaning donors. For their gifts to be deductible, however, the charity must retain complete control over distribution—even if that means the donor’s wishes may not be completely honored.**

 **The CAREFUL Coalition has submitted draft guidelines to the IRS to provide much needed guidance in this area. For a free copy, fax your request to CAREFUL at 703-761-5023.**

#### **4.2 Investment Fund Fails to Qualify as Exempt Organization.**

A fund established by a private individual to serve as an investment vehicle for donors has been denied 501(c)(3) status because it did not operate exclusively for exempt purposes. The fund provided investment services to donors on condition that they make contributions, which the trustee would invest according to the donors’ directions. Income from those investments would go anonymously to charities specified by the donors. The IRS said the fund merely circumvented restrictions on private foundations and charitable deduction limitations. The fund appealed, but a federal district court agreed with the IRS, finding that the investment services the trustee provided to donors were not an exclusively exempt purpose. *The Fund for Anonymous Gifts v. IRS*, U.S. Dist. Ct. (D.C. Civ 95-1629, 1997).

★ **The fund’s arrangement permitted donors to make risk-free investments, over which they could retain control,**


**and still claim a charitable deduction, the court concluded. Although income from investments benefited other charities, the court said this was not an exempt activity because it primarily benefited donors.**

## **5. State Rules & Regulations**

### **5.1 Religious College Excluded From State Funding Program.**

A federal judge ruled last month that Maryland officials were acting within the bounds of the Constitution when they denied funding to Columbia Union College, a religious school run by the Seventh-day Adventist Church. Since 1992, Maryland has refused to consider the college in the annual Joseph Sellinger Program, which provides state funds to private colleges (including religious schools) so long as the funds are used for non-sectarian purposes. Maryland claims Columbia’s ties to the Seventh-day Adventists and its required religious services for students make it “pervasively sectarian.”

★ **Lawyers pursuing the case for Columbia say Maryland’s decision violates First Amendment free speech and free exercise of religion protections, as interpreted in a string of Supreme Court rulings since 1976. They plan to appeal the ruling to the Fourth Circuit.**

 **A new Nonprofit Alert® Memo explores the legal issues of accepting government funding: NP9701-2, *Religious Colleges’ Participation in Tax-Exempt Financing Programs*. See back page to order.**

### **5.2 Rhode Island Follows Pennsylvania in Denying Bible Exemption.**


The last two issues of *Nonprofit Alert* reported that an appeals court in Pennsylvania struck down the state’s sales tax exemption on Bibles and religious literature. Now, a Rhode Island district court has followed suit, ruling that a 15-

## ***NPA Highlight of the Month***

### **State Sales Tax Trends: No Exemptions for Nonprofit Contractors**

On two separate occasions, contractors performing work for nonprofits in two different states have recently been denied sales tax exemptions despite the availability of those exemptions to the nonprofits themselves. In Oklahoma, the State Tax Commission ruled that sales of merchandise to contractors acting on behalf of a church are subject to state sales taxes. This case, the first of its kind to reach the Oklahoma Commission, stemmed from a company’s challenge to a tax assessment it received for failing to collect and remit proper taxes on certain sales it made to contractors who were working for local churches and religious groups. The company produced evidence of the contractors’ work for churches and religious groups, which are all exempt from Oklahoma sales taxes. In good faith, the company did not charge those contractors sales taxes because it assumed the exemption applied, but the Commission did not relieve the company of liability even under the law’s good-faith exception. OK Tax Comm. No. 97-05-22-008.

A similar case arose this fall in Florida, where the Department of Revenue ruled that equipment rentals by a contractor for a nonprofit organization were not exempt from sales taxes. The contractor performed work for a tax-exempt organization that builds low-cost housing for needy families. Although purchases by the exempt organization itself are not subject to sales taxes, the state said those tax breaks do not extend beyond the organization directly, regardless of any working arrangements or agreements the organization may have with contractors to perform its exempt purposes. FL TAA 97A-046.

 **Although these rulings are limited to two states, other cash-strapped states will undoubtedly follow. A simple solution is for the exempt organization to make such purchases outright, although this may be impractical in many instances and could even cause the exempt organization to assume unwanted liability.**

15-year old Rhode Island law exempting religious literature from sales taxes is unconstitutional. *Thomas Ahlburn, et. al., v. R. Gary Clark, Tax Administrator*, Doc. 97-30148 (Dist.Ct. 1997).

### 5.3 Virginia Supreme Court Limits Wrongful Termination.

Virginia's highest court has ruled that a 1995 amendment to the state's Human Rights Act prohibits a common law cause of action for wrongful termination based solely on public policies. Thus, it is no longer possible to maintain a wrongful discharge tort action in Virginia for discrimination other than that specifically prohibited by the state's Human Rights Act. That law prohibits only discrimination on the basis of race, color, religion, national origin, sex, or age (if the employee is at least 40 years old). *Doss v. Jamco, Inc.*, No. 970703 (Va. Sup.Ct. 1997).

★Unlike federal law, Virginia's Human Rights Act makes no mention of other conditions such as pregnancy or disability. The plaintiff in this case claimed she was wrongly terminated when her supervisors learned she was pregnant. This ruling leaves her with only federal law remedies.

## 6. Gifts & Fundraising

### 6.1 Charitable Gift Annuities Don't Trigger Taxes, IRS Rules.

A 501(c)(3)'s issuance of a deferred charitable gift annuity does not produce unrelated trade or business income, nor does the annuity's investment income, the IRS has ruled. If income on the annuity were taxable, the IRS reasoned, then the purpose for exempting charitable annuities from taxation would be useless. IRS LTR 9743054.

★Protracted litigation against several Texas charities that issued annuities has confused this whole issue. But this ruling makes clear the IRS' position on annuities as legitimate income-producing mechanisms for charities.



NP9403-2, *Guidelines for Charitable Gift Annuities*, summarizes the necessary legal steps for implementing a successful annuities program.

**6.2 University Licenses Name, Logo for Restaurant.** Many charities have cut lucrative licensing deals in recent years, allowing their names and logos to be used on everything from cereal to documentary films. But Ohio State University is the first to license its name and logo to a theme restaurant. The Buckeye Hall of Fame Cafe opened in October under a 20-year licensing agreement that nets the university 4% of sales on Ohio State memorabilia such as sweaters and water bottles.



**Licensing agreements and other entrepreneurial activities often create unrelated business income. Learn how to manage or avoid it altogether with NP9110-1, A UBIT Primer for Nonprofits.**

## 7. Executive Items of Interest

**7.1 Quote of the Month.** "WE'RE CERTAINLY NOT GOING TO BE COPS LOOKING FOR THESE THINGS, BUT WE HAVE THE POWER AND THE WHEREWITHAL TO INVESTIGATE AND ENFORCE THEM." —William Haldin, spokesman for the Connecticut Attorney General, commenting in *Chronicle of Philanthropy* about the responsibility of state attorneys general for enforcing donor gift conditions and limitations. (See story at ¶1.2, above).

### 7.2 Common Fundraising Forms Available for Download.

This government-run web site allows charities to obtain fundraising registration forms currently accepted in 21 states.

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