



# Nonprofit Alert®

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

## 1. Nonprofit Overview

### 1.1 *Overhaul at the IRS: What Does It Mean for Nonprofits?*

Late last month, the White House finally signaled its approval of a Republican-sponsored plan to overhaul the Internal Revenue Service, which includes a proposition to create an 11-member oversight board made up of experts from government and the private sector. The board would be responsible for evaluating and approving all the IRS's internal operations, including long-term planning and budgeting. The plan also provides new rights for taxpayers, such as:

- shifting the burden of proof to the IRS instead of the taxpayer;
- streamlining the process for taxpayers to recover their costs when defending a case against the IRS;
- allowing taxpayers to collect damages if the IRS has wrongly accused them; and
- extending the attorney-client privilege to professionals authorized to practice before the IRS, such as accountants and CPAs. This is good news for nonprofits, especially if an organization finds itself in litigation with the IRS. However, the plan does not address whether the IRS Exempt Organizations ("EO") Division will strengthen its regulatory oversight of nonprofits—a goal the IRS has long pursued as nonprofits rapidly multiply in numbers.

★ **Two prominent groups support the IRS's goal of increasing the EO Division's oversight operations. The National Council of Nonprofit Associations and the Council on Foundations say funding increases for the Division should come through excise taxes on private foundations. Increased regulatory oversight of nonprofits will only benefit the charitable community in the long run, they believe. (See related quote at ¶7.1, back page). Although Congress increased the IRS's budget by 10% this year, very little of that amount is slated for the EO Division.**

### 1.2 *Proposed Rules Address Concerns Over Charity*

**Disclosure.** A law passed last year requires charities to disclose their tax returns (Form 990's) to the public upon request, but the law doesn't take effect until the IRS issues final rules explaining how the requirements will be implemented. (*NPA*, Sept. 96). Now, the IRS has issued proposed rules that give charities a break on the disclosure requirement if they already post their Form 990's and applications for tax exemption on the Internet. A charity may post the documents on its own web page or submit them to a database-type web site maintained by another entity. Additional requirements apply—such as maintaining the accuracy of posted

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documents, making them available for download, and posting them in the same format used by the IRS—but overall, the option of Internet posting relieves many charities of what was expected to be a significant administrative burden.

★ **The proposed rules specify an exception to the disclosure requirement for charities that are harassed by opponents whose motivation is merely to create additional work for the charity by making repeated requests for disclosures. The rules also allow reasonable copying charges, but charities cannot charge more than the IRS charges for copies (currently \$1 for the first page and 15 cents for each additional page).**



**Although the rules are yet to be finalized, it's not too early to begin thinking of how your organization will comply. For details of the law, order NP9608-1, *Avoiding the Snares of Intermediate Sanctions*. See back page to order.**

### 1.3 *Legislation Would Allow Deductions for Non-Itemizers.*

Rep. Philip M. Crane (R-IL) has introduced a bill that would allow non-itemizers to deduct at least some of their charitable contributions. Known as the **Charitable Giving Relief Act**, the bill is designed to encourage additional giving by providing tax incentives to the 75% of taxpayers who previously couldn't claim charitable deductions because they file non-itemized tax returns. If passed, the bill would permit non-itemizers whose cumulative annual charitable contributions exceed \$500, to deduct 50% of any charitable contributions they make over that amount. A similar provision existed in the tax code until 1986 when Congress failed to renew it.

★ **An estimated 84 million taxpayers do not itemize their tax returns. An independent analysis by the accounting firm of Price Waterhouse predicts the bill, if passed, would encourage non-itemizers to make an additional \$2.7 billion in charitable contributions annually.**

## 2. Liability & Risk Management

### 2.1 Charity Trustees Criticized for Excessive Compensation.

As the wealthiest charity in Hawaii, the Bishop Estate manages a broad range of real estate and business ventures worth an estimated \$5-\$10 billion. But allegations are surfacing about questionable spending practices of the charity's trustees, who reportedly collect an average of \$880,000 each in annual salaries from the charity. Founded by Hawaii's last princess in 1883, the Bishop Estate runs the Kamehameha Schools for students of native Hawaiian ancestry. Critics allege that the trustees spent more than \$1 million last year in legal and consulting fees in a failed attempt to defeat federal legislation that prohibits excessive compensation to charity officials. At the same time, the trustees cut funding for a successful education program for small children. The state attorney general is leading an investigation.

★ The IRS is also investigating whether the trustees' salaries constitute "excessive compensation" under the intermediate sanctions law passed last year. If the investigation continues, this could be the first case prosecuted under that law.

➡ How do you determine what's "excessive" when applied to executive compensation? NP9102-7, *Establishing Reasonable Compensation for Nonprofit Leaders* offers practical answers. See back page to order.

### 2.2 Anonymous Tip Leads Investigators to Embezzling Executive.

A grand jury has indicted the former president of the Medical Foundation of East Carolina University for embezzling \$177,000 in foundation funds. Investigators discovered the fraud after an anonymous caller warned the state auditor about financial abuses inside the foundation that supports the university's medical school. The auditor contacted the university, which then began an internal audit turning up several instances of abuse, including duplicate travel reimbursements to the president and equipment purchases from a company that was partly owned by university employees.

★ Investigators said the misdeeds likely would have been undiscovered but for the anonymous tip. The foundation has now added internal controls to monitor finances.

➡ You can't afford to rely on anonymous tips. Order NP9106-2, *Accounting and Fiduciary Guidelines for Nonprofits*, to learn more about 28 internal control procedures your organization can implement.

2.3 *New Era Founder Sentenced to 12 Years.* A federal judge has sentenced John G. Bennett, Jr., former president of the

Foundation for New Era Philanthropy, to 12 years in prison with no chance for parole after Bennett was found guilty earlier this year on 82 counts of defrauding hundreds of charities, plus money laundering and tax violations. New Era reportedly collected over \$350 million from more than a thousand nonprofits, including colleges, museums, and religious organizations. The foundation turned out to be nothing more than a Ponzi scheme, and when it folded in 1995, nonprofit organizations that had funds on deposit with New Era lost a bundle.

★ Bennett faced a maximum of 25 years in prison, but the judge opted for a lesser sentence because of Bennett's cooperation with the federal bankruptcy trustee who is overseeing the process of returning funds to those charities

hurt by the scheme.

## 3. Employees & Volunteers

### 3.1 Credit Checks Require Employees' Written Authorization.

Employers must now obtain their employee's or potential employee's written consent to conduct credit checks, regardless of whether the checks are for legitimate business purposes. The new requirement is pursuant to the Consumer Credit Reform Act, effective this year. Employers may still use information gained from a credit check to make hiring and promotion decisions, but they must inform employees that their credit records are being examined. The law requires employers to:

- clearly notify employees and/or potential employees that a credit check will be conducted for employment purposes;
- secure written authorizations from employees or potential employees before instituting any form of credit check;
- certify to the credit reporting agency that all required disclosures have been made to the employee being investigated;
- provide the employee with a copy of the credit report and a summary of his/her rights *before* taking any action based on the report, such as dismissal or denial of promotion.

★ The law also implements a procedure for employees to use in challenging the accuracy of credit reports. If errors are found, the credit bureau that issued the faulty report must correct it, and the employee is entitled to have his/her employment reconsidered in light of the corrections.

➡ To compare and evaluate your employment practices with a 102-item matrix of permissible and inadvisable pre-employment inquires, order NP9402-1, *Minimizing Employment Liability Through Responsible Hiring & Supervision*. See back page to order.

3.2 *Court Upholds Same-Sex Harassment Because of Perception.* Stretching the reach of Title VII's sex discrimination prohibition to new limits, the 7th Circuit U.S. Court of Appeals has ruled that federal law prohibits workplace harassment by males of other males when the harassment occurs as a result of one's discriminatory *perception*. The case stemmed from alleged harassment by a heterosexual male against another male who was perceived as effeminate or gay. *Doe v. City of Belleville*, 119 F.3d 563 (7th Cir. 1997).

★ While not expressly extending Title VII's coverage to sexual orientation discrimination, this ruling provides a basis for arguing in favor of that premise. Some clarity may

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come, however, when the Supreme Court considers during this term whether Title VII covers same-sex harassment in *Oncale v. Sundowner Offshore Services*, No. 96-568.

➔ Many nonprofits now have policies against sexual harassment, but a Supreme Court ruling could require revisions in those policies. Make sure your policy complies with current law. Review NP9201-2, *Sexual Harassment Policy for Nonprofit Employers*.

## 4. Tax-Exempt News & Issues

**4.1 Housing Partnership Relates to Exempt Purpose.** A nonprofit organization that develops housing for low-income individuals may enter a partnership arrangement to develop an apartment complex without endangering its exempt status, the IRS has ruled. The nonprofit planned to assume a position as a general partner in a limited partnership to build apartments. Because of its position, the nonprofit would provide management and development services to the partnership on a regular basis. These services would normally be characterized as a trade or business, the IRS said, but in this case they were substantially related to the nonprofit's exempt purpose. Therefore, income received from performing such services would not be subject to unrelated business income tax nor would any income from the organization's share of partnership profits. IRS LTR 9736039.

➔ Entering joint ventures or partnerships raises many tax questions, although such arrangements can significantly bolster the accomplishment of exempt purposes. For more information, order the newly updated NP9304-1, *Organizing the Nonprofit and Its Subsidiaries*.

**4.2 Bar & Grill's Fund Raising Group Isn't Exempt.** The Tax Court has upheld the IRS's denial of exempt status to KJ's Fund Raisers, Inc., founded by the owners of a bar in Vermont called KJ's Place. The court said the group served a substantial non-exempt purpose—namely that of promoting the business of

KJ's Place. Since 1993, the organization has operated from KJ's Place where it sells lottery tickets to customers, who are also solicited to buy drinks at the bar. Funds from those sales covered salaries of \$6,000 each to the bar's owners, who were original officers of the organization, plus \$6,000 in rent to the bar. But the organization also distributed over \$12,000 to state and local charities in recent years. It did not conduct any other form of solicitation or fund raising, nor did it operate in any other bar or establishment apart from KJ's Place. The court said the organization was operating primarily to attract patrons to KJ's Place since all its publicity featured the bar. *KJ's Fund Raisers v. Commissioner*, T.C. Memo, 1997-424.

➔ Although the violations in this case are fairly evident, private inurement is often more subtle. For illustrations of problem areas and acceptable ventures, refer to NP9109-4, *The Essential Don'ts of Private Inurement*. See back page to order.

## 5. State Rules & Regulations

### 5.1 Florida Registration Law Challenged as Unconstitutional.

Florida's Pinellas County has one of the broadest fund raising registration requirements in the country. Charities and professional solicitors must register annually, provide detailed financial reports, list their clients, officers and fund raising materials, and pay fees up to \$120 per year. There are no exceptions for solicitations that originate outside the county, which means the law covers every charitable solicitation in Pinellas County, even those done electronically via TV, radio, or the Internet. But a coalition of charities thinks the law goes too far. The coalition, American Charities for Reasonable Fund Raising Regulation, has filed a federal lawsuit claiming the ordinance violates the Constitution by interfering with commerce and restraining free speech. The coalition says it

### NPA Highlight of the Month

## CAREFUL Coalition Makes Inroads at IRS

Deputized fund raising is one step closer to acceptance by the IRS after representatives of the CAREFUL Coalition met with IRS officials October 24 to discuss public guidelines. Deputized fund raising is the practice used by hundreds of tax-exempt organizations in which staff members are responsible for raising funds to support their sphere of work. The Coalition was formed after the IRS denied exempt status to Great Commission Ministries, based on its deputized fund raising practices. Although the IRS eventually reversed its denial after an appeal to the Tax Court, confusion continues over deputized fund raising practices and the deductibility of contributions received through this method. IRS representatives, including the top two officials from the IRS Exempt Organizations Division and the primary IRS expert on charitable contributions, acknowledged the need for public clarification of this issue. They instructed the Coalition to submit draft guidelines for further discussion. Milt Cerny, tax counsel for Campus Crusade for Christ and spokesperson for the Coalition, reported following the meeting that he was optimistic these efforts will result in helpful guidance to nonprofits and will safeguard the legitimate practice of deputized fund raising.

★ Now that the CAREFUL Coalition has made inroads at the IRS, it needs your support to ensure that deputized fund raising guidelines, which are beneficial to the nonprofit community, become a reality. For further information, please contact Stephen King at Gammon & Grange, (703) 761-5000 or at shk@gandglaw.com.

intends to challenge several more local regulations around the country to help ease the regulatory burdens being forced on nonprofits.

★ **This is the first reported backlash against the wave of increased regulations that many cities and counties have imposed on nonprofits in recent years. If the coalition is successful, hundreds of other local registration requirements could be challenged.**

### 5.2 Pennsylvania's Denial of Bible Exemption Under Appeal.

Last month, *Nonprofit Alert* reported on a state appeals court ruling in Pennsylvania that held the state's sales tax exemption for the sale of Bibles and other religious publications was unconstitutional because it was based solely on the religious nature of the item. (*NPA*, Oct. 97). Now, that ruling has been appealed, and the Pennsylvania Department of Revenue has indicated in the meantime that it is maintaining its previous position on the issue.

★ **This means the Department of Revenue still considers the religious materials exemption valid unless and until the lower court's decision is upheld on appeal. So for now, the sale of Bibles and other religious publications are exempt from state sales tax in Pennsylvania. Watch *NPA* for updates.**

## 6. Gifts & Fund Raising

### 6.1 Foundation Trustees Locked in Legal Battle Over Removal.

Trustees of the private Culverhouse Family Foundation, established by Hugh F. Culverhouse, former owner of the Tampa Bay Buccaneers football team, are facing a legal scrimmage over their right to stay in power. Before Culverhouse died in 1994, he instructed the foundation to give 20 percent of its assets to the University of Alabama upon his death. Last July, the foundation trustees filed suit in a Florida court seeking permission to forego Culverhouse's instructions regarding the 20 percent. They claim his letter of instruction was not a mandatory edict that they are bound to honor. The university retaliated by asking the court to remove the trustees for failure to abide by Culverhouse's clear intent and instructions, as stated in his signed letter of instruction.

Culverhouse also pledged \$10 million to the university's business school, but at his death, only \$1-million had been paid. His widow filed suit, claiming the pledge was improperly arranged by trustees of the unitrust from which the payments were made. She successfully had those trustees removed, but the dispute is still pending.

## 7. Executive Items of Interest

**7.1 Quote of the Month.** "REGULATION ISN'T ALWAYS A DIRTY WORD. IF DONORS, VOLUNTEERS, AND COMMUNITY LEADERS HAVE STRONGER CONFIDENCE THAT THE NONPROFITS THEY SUPPORT ARE UNDER APPROPRIATE SCRUTINY, EVERYONE IS GOING TO BE MORE LIKELY TO CONTINUE GIVING THEIR FINANCIAL AND VOLUNTEER SUPPORT."—Ann Mitchell Sackey, Executive Director, National Council of Nonprofit Associations, on the need for changes at the IRS, as quoted in *Chronicle of Philanthropy*. (See related story at ¶1.1, above).

### 7.2 Nonprofit Postage Charts Compare Past & Future Rates.

The National Federation of Nonprofits is offering a set of charts that show current and proposed nonprofit postage rates, as proposed by the Postal Service for 1998.



**Copies of the charts are available upon request from NFN at (202) 628-4380, by fax (202) 628-4383, or by sending an e-mail to [nfndc@aol.com](mailto:nfndc@aol.com).**

**Ordering Information:** Memos referenced in the *Nonprofit Alert* are \$20 per memo *prepaid* (\$10 for firm clients). Five or more copies of the same memo are bulk priced at \$5 each.

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