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Nonprofit *Alert*®

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

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Leaders of Texas Charity Hit With $30 Million Verdict for Damages

A Texas jury recently found two officers of the Carl B. and Florence E. King Foundation liable for over $30 million in damages from excess benefits they received from the Foundation. Former President Carl Yeckel was held liable for nearly $16 million in compensatory and punitive damages, while former Secretary Thomas Vett was held liable for nearly $6 million in damages. The jury also voided Vett and Yeckel's pension contracts, valued at $10.8 million.

The Foundation was established by Carl and Florence King to provide scholarships to underprivileged students. Yeckel, the Kings' grandson, allegedly received more than $5.4 million in cash compensation between 1993 and 2003, while Vett received more than $2.5 million during that period. In 2000, the Foundation spent more on salaries for Yeckel and Vett ($2.5 million) than it did on grants ($1.5 million). In addition, Vett and Yeckel enjoyed apparently unrestricted use of vehicles and credit cards owned by the King Foundation, and received excessive insurance and medical benefits among other perks.

Acting on a complaint from Yeckel's sister, the Texas Attorney General investigated the alleged misappropriations, then sued Yeckel, Vett, the other Foundation Board members, and the Foundation's attorney in 2002. The King Foundation, represented by a new Board of Directors, joined the lawsuit in 2003. The Attorney General alleged in the suit that Yeckel and Vett received excessive compensation and other benefits, violated their fiduciary duties as Board members, and failed to manage the Foundation in accordance with its Bylaws, the Texas Nonprofit Corporation Act, the Internal Revenue Code, and other applicable law. The Foundation's Board allegedly failed to hold annual meetings, prepare budgets or financial reports, or exercise ordinary care over the Foundation or its assets. The Attorney General also alleged that the Foundation's attorney committed legal malpractice by failing to exercise reasonable and ordinary care in rendering legal services to the Foundation.

The jury in Travis County, Texas found Yeckel and Vett guilty of breaching their fiduciary duties as officers and directors of the Foundation. The other defendants settled before the trial. Meanwhile, the Foundation has a new Board of Directors overseeing administration of the Foundation's scholarship program and distributions from its remaining $43 million in assets.

➥ **It is becoming more common for state attorneys general to sue charities for paying excessive compensation to insiders. Also, the IRS is stepping up its investigations of and imposition of Intermediate Sanctions excise taxes on insiders of nonprofits who receive excess benefits, and on the organizational managers who approve such excess benefits. As reported in the October / November 2004 edition of the Nonprofit *Alert*®, the IRS reported that it is in the process of auditing the compensation data and / or practices of nearly 2000 tax exempt organizations. Kathleen Sullivan, the new IRS Exempt Organizations Division Director, has pledged to focus more of her Division's resources on enforcement programs that target charities with the greatest compliance risks, including charities that may be paying excessive compensation to insiders. For information on how to identify potential excess benefits and take steps to avoid potential Intermediate Sanctions liability, read Gammon & Grange's Nonprofit *Alert*® Memo, *Intermediate Sanctions Law*. [Click here to order]**

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Congress Curtails Deductions for Gifts of Vehicles, Intellectual Property

On October 22, 2004, President Bush signed legislation that significantly limits the tax deductions available for contributions of vehicles and intellectual property to charity. Congress intended the legislation, the ***American Jobs Creation Act*** (HR 4520), to limit inflated, above fair market value deductions for such gifts.

The vehicle deduction portion of the Act applies only to vehicles worth over $500. It provides that if a charity sells a donated vehicle that it does not plan to improve or use, the donor may only deduct the amount for which the charity sells the vehicle–whether or not that amount reflects "blue book" or fair market value. The donor must also provide the IRS with the charity's contemporaneous written acknowledgment of the contribution. This acknowledgment must be provided by the charity to the door within 30 days of the sale of the vehicle, and must include (1) the donor's name and taxpayer ID number, (2) the vehicle identification number, (3) the gross proceeds from the charity's sale, (4) certification that the vehicle was sold in an arm's length transaction, and (5) a statement that the donor's deduction may not exceed the amount of the charity's proceeds from the sale.

If a donor contributes a vehicle to a charity that plans to use or improve the vehicle, the donor may deduct the fair market value of the vehicle if the donor provides the IRS with a contemporaneous written acknowledgment from the charity, *i.e.,* an acknowledgment given no more than 30 days after the donor's contribution of the vehicle to the charity. The charity's acknowledgment must include a certification (1) describing the charity's intended use or material improvement of the vehicle, and the intended duration of such use; and (2) that the charity will not transfer the vehicle for consideration before the completion of such use or improvement. The charity must provide the IRS with copies of either of the contemporaneous written acknowledgments that the charity provides to vehicle donors.

The Act also limits charitable deductions for contributions of patents, copyrights, and the other intellectual property to charity. A donor of such property may only deduct the lesser of the donor's tax basis or fair market value of the property. Thereafter, the donor may take additional deductions based on a percentage of the income received or accrued by the charity with respect to the property (*i.e.,* 100% of income for first two years, declining by 10% each year thereafter) after the charity has received or accrued income from the property that exceeds the amount of the donor's initial deduction. Such "income" must be allocable to the property itself, not to activities in which the property is used by the charity. To take such additional deductions, the donor must notify the charity at the time of the donation of the donor's intent to take the additional deductions. Then, the charity must annually report any income allocable to the property to both the donor and the IRS.

The intellectual property provisions of the Act are retroactively effective as of June 4, 2004. The vehicle deduction provisions of the Act will become effective on January 1, 2005.

➥To see the text of this Act regarding limitations on charitable contribution deductions for vehicles and intellectual property, click on http://thomas.loc.gov, enter "HR4520" in the search box, then review Sections 882-884.

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Liability & Risk Management

Church Bookkeeper Imprisoned for Fraud

A Milwaukee court has convicted a church bookkeeper of fraud and theft, sentenced her to four years in jail, and ordered her to pay $518,000 in restitution after she admitted to embezzling church funds.

Rebecca Piekarski, formerly the bookkeeper at Gesu Catholic Church in Milwaukee, confessed to stealing over $500,000 of church funds to feed her gambling habit. From mid-2001 through February 2003, she reportedly wrote 154 unauthorized checks to herself of more than $200,000 and stole another $300,000 from church collections. She concealed the theft by falsifying parish books and posting the checks as issued for staff bonuses, food, and other church-related expenses.

Church officials noticed the decline in collections, but did not initially suspect Piekarski. The church lacked procedures for verifying that Piekarski's expenditures were for church-related expenses, and allowed her to count and deposit church collections without proper oversight. Another employee discovered the embezzlement when she found a cancelled check made out to Piekarski. The church then dismissed Piekarski and reported her theft to the police.

➥ **Unfortunately, this case is not isolated. Dozens of churches–from San Antonio to Worcester, Massachusetts, from Little Rock to Brooklyn—have been victims of theft and embezzlement this past year at the hands of dishonest clergy or lay employees. Within two weeks of the Nonprofit *Alert*® going to press, a criminal investigation of a former priest was announced in Phoenix, Arizona following a church audit, and a 41 year old bookkeeper was sentenced to 90 days in jail and ordered to pay $45,000 in restitution to her former church employer in Aberdeen, South Dakota. Sadly, most of these church cookie jars have been sitting on the low shelf, with the parents gone. In other words, much of this fraud could have been prevented— or at least uncovered—much sooner with the implementation of basic internal financial controls. To prevent this kind of embezzlement from victimizing your church or nonprofit, check authorization and processing functions should be segregated from the signing and recording functions, which should in turn be segregated from the bank reconciliation functions. Any two authorized individuals should serve as signatories for all checks drawn from the organization's depository accounts in excess of a non-routine amount. Also, all disbursements of a nonprofit's funds should be made for items contained in the organization's budget, or for items separately approved by the board. Churches that take offerings during worship services should ensure that at least two persons are present when counting and recording church collections. For more helpful recommendations on procedures to protect your nonprofit's assets, read Gammon & Grange's Nonprofit *Alert*® Memo, *Accounting and Fiduciary Guidelines for Nonprofits*. [To review a checklist of 23 easy-to-implement internal accounting controls for your nonprofit, click here.]**

First Amendment Does Not Protect Church From Lawsuit By Terminated Minister

The Ninth Circuit Court of Appeals has ruled that the First Amendment does not prevent a minister who was terminated by her church from suing the church for damages from sexual harassment and retaliatory discharge.

Rev. Elvig, a Presbyterian minister, alleged that her supervisor and her church's senior minister, Rev. Ackles, made unwelcome sexual gestures, remarks, and advances toward her at their church. She reportedly confronted Ackles, who allegedly retaliated against her by taking away her preaching assignments. She then made a formal complaint to the church, which allegedly took no action to stop the harassment or alleviate the hostile working environment. The church then placed Elvig on unpaid leave, and the Presbytery terminated its employment relationship with her. Elvig sued the church in federal district court for sexual harassment, retaliatory discharge, and negligent supervision.

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Terminated Minister...[continued from page 3]

The district court dismissed all of Elvig's claims. It held that consideration of the claims would violate the church's First Amendment religious freedom rights to self-governance and selection of its own ministers, and would unconstitutionally entangle the court with the church's internal governance in violation of the establishment clause of the First Amendment. The 9th Circuit Court of Appeals agreed that the church was constitutionally protected in making employment decisions concerning its ministers. However, the Court determined that because adjudication of Elvig's sexual harassment and retaliatory discharge claims would "involve a purely secular inquiry," those claims should be considered by the district court under Title VII of the 1964 Civil Rights Act. The Court added that the church could make a defense that the sexual harassment was consistent with its doctrine, but had failed to do so.

After the federal district court dismissed her case, but before the 9th Circuit issued its opinion, Elvig filed suit in Washington state court against the church and its Presbytery, alleging sexual harassment, retaliation, defamation, and negligent supervision. The state court dismissed all of these claims. It agreed with the federal district court that consideration of any of the claims would violate the Church's First Amendment rights to autonomy and self-governance, as such consideration would involve examination of the church's doctrine and ecclesiastical decision-making. The court distinguished its decision from the 9th Circuit's decision on procedural grounds: the court ruled on a summary judgment motion, which enabled the court to review substantive evidence of the church's internal dispute resolution process, whereas the 9th Circuit did not consider such evidence. In particular, the state court held that it could not examine the Presbyterian church's dispute resolution process, governed by its Book of Church Order, that the church followed in reviewing Elvig's complaints and terminating her employment.

Despite the state court's ruling, Elvig's sexual harassment claims against the church are still pending in federal district court, on remand from the 9th Circuit. *McDowell v. Calvin Presbyterian Church, Will Ackles*, 375 F.3d 951 (9th Cir. 2004); *McDowell v. Ackles, Terry Nelson, Calvin Presbyterian Church, and North Puget Sound Presbytery*, 98 P.3d 524 (Wa. Ct. App. 2004).

➥ **In a somewhat similar case, a federal court in Kansas recently held that a Presbyterian church and its Presbytery could be liable for a staff member's repeated acts of sexual harassment. An ordained female minister employed by the church alleged that the church's director of music subjected her to sexually inappropriate behavior over the course of 5 years. After the minister reported this behavior to church leaders, the church dismissed her despite her apparently satisfactory job performance. She then sued for sexual harassment and retaliation. The court held that the church could be liable for the director of music's acts on the basis of an "intentional failure to supervise," since it had the ability to control the director of music, "knew or should have known of the necessity and opportunity for exercising such control," and failed to exercise such control to prevent the harassment. *Doloquist v. Heartland Presbytery*, 2004 WL 74318 (D. Kansas 2004). These cases underscore two lessons: most courts still show considerable deference to churches and religious organizations when employment or governance decisions are clearly made according to established (and ideally published) religious principles. Conversely, ad hoc decisions that demonstrate little evidence of due process or application of well publicized religious principles are almost a flashing neon welcome sign inviting court involvement. For an overview of sexual harassment law and policy recommendations for minimizing the risk of sexual harassment-related liability, see Nonprofit *Alert*® Memo, *Sexual Harassment Policy: Implement and Educate*. [Click here to order]**

Nonprofit and Tax Exempt Organization Issues

IRS Probes Insider Transactions in Expanded Form 1023

The Internal Revenue Service has expanded its Form 1023, *Application for Recognition of Exemption*. This is the form that most charities must submit to the IRS to obtain recognition of their tax exempt status. It has been expanded from 9 to 12 pages to gather more information about charities' transactions with their officers, directors, and other insiders.

The primary additions are questions regarding compensation, transactions between the applicant organization and insiders, and other potential conflicts of interest and excess benefits. For instance, the Form now requires applicants to list the names, addresses, qualifications, duties, and average hours worked of (1) the five highest compensated employees to whom the organizations pay over $50,000 per year, and (2) the five highest compensated independent contractors to whom the organizations pay over $50,000 per year. The Form also requires additional information on an applicant's fundraising, intellectual property, and relationships with and grants to third parties. Various schedules to the Form 1023 for schools, churches, supporting organizations, child care organizations, hospitals, and homes for the elderly have also been expanded.

The IRS acknowledges that the new Form 1023 will "require additional effort on the part of the organization" to complete, but predicts that the new Form will reduce the need for follow-up questions, and thus reduce processing time. The IRS also notes that the Form incorporates related forms (*i.e.*, 8718, 872-C) that the IRS previously required applicants to file separately in conjunction with the Form 1023.

➥**The IRS will accept both the old and new Form 1023 applications through April 30, 2005, at which time it will only accept the new Form. The new Form is available on the IRS web site at http://www.irs.gov/pub/irs-pdf/f1023.pdf. The old Form is no longer available from the IRS.**

IRS Fences the Tax Exemption Table

A nonprofit organization must be organized and operated *exclusively* for tax exempt purposes as a condition of receiving and continuing to enjoy tax exemption. The IRS routinely denies applications for tax exemption that fail to establish the applicants will meet this standard. The following ten recent IRS rulings reflect some of the IRS's most common reasons for denial of tax exemption:

- Low-income housing organization: denied exemption because organization did not establish that its operations would be charitable and that it would not serve private interests.
- Anti-landmine group: denied exemption because group did not provide enough detail about its program to establish that it would be operated exclusively for exempt purposes.
- Organization to assist Lou Gehrig's Disease victims: denied exemption because the IRS determined that it was operated for a few victims rather than for broader public interests.
- Church (with four members): denied exemption because church failed to show that it would be organized and operated exclusively for tax exempt purposes, and that its net earnings would not inure to the benefit of the few individuals who operated the church.

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Tax Exemption Table....[continued from page 5]

- Country club equipment lessor: denied exemption because the IRS determined that the organization's purposes and activities did not further any tax exempt purposes.

- Recreation center: denied exemption because IRS determined that the operation of a retreat center to offer manicures, massages, and a children's sports camp does not further charitable purposes, even though the organization offered discounts to low-income families.

- Business organization: denied exemption because IRS held that the resources of this organization, which mentors entrepreneurs and connects them with investors and educators's resources, would not be devoted to charitable uses.

- Art show organizer and scholarship provider: denied exemption because IRS determined the organization's primary activity—running a "selling mart for artists"–to be a non-charitable business.

- Film and theater production company: denied exemption because the company, which provides financial and logistical assistance to creators of low-budget films and theater productions, planned to sell commercially viable films, and thus had "commercial overtones."

- Credit counseling agency: denied exemption because the IRS determined that the company, which provides debt counseling and education, was operated in a "commercial manner" for the benefit of a related for-profit company.

Charities Sue Federal Government Over CFC Anti-Terrorism Requirements

As reported in the October / November 2004 issue of the **Nonprofit *Alert*®**, the Office of Personnel Management ("OPM") has begun requiring charities to certify, as a condition of participation in the Combined Federal Campaign ("CFC"), that they do not employ individuals or give funds to organizations found on certain terrorist watch lists. Thirteen nonprofit organizations, including Amnesty International, the NAACP, the ACLU, the OMB Watch, and the Natural Resources Defense Council, sued the federal government in November in an attempt to block this new regulation.

The lawsuit, filed in the U.S. District Court of the District of Columbia, charges that the certification requirement is prohibited by a 1987 federal law that prevents OPM from changing CFC eligibility requirements. The 13 charity plaintiffs also allege that OPM overstepped its authority by imposing new rules without first providing notice of proposed rules in the Federal Register and seeking comments, and that the terrorist watch lists are filled with errors.

The CFC is the federal government's annual charity drive in which federal employees can designate contributions to qualifying charities. This summer, OPM imposed its anti-terrorism certification requirement, which requires charities to certify in their applications to participate in the CFC that they do not knowingly employ any individual or give money to any organization on 14 terrorist watch lists developed by the U.S. government, the United Nations, and the European Union. Thus, as part of the CFC application and certification process, a nonprofit must check the names of more than 6,000 people on these lists who are allegedly connected to terrorist groups. Several charities have withdrawn from the CFC in recent months because of this certification requirement, which they believe to be unduly burdensome.

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