




# Nonprofit Alert®

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

## 1. Nonprofit Overview


**1.1 New Copyright Law Protects On-Line Material.** Under a new law, it is now illegal to reproduce or distribute certain copyrighted on-line material, even if it is done with no profit motive. This new law makes it a felony to reproduce or distribute ten or more copies of copyrighted material if the copies have a total retail value more than \$2,500. Reproducing or distributing one or more copies with a retail value greater than \$1,000 is a misdemeanor.

★ **The penalties only apply if the violations are willful. Limited scholarly or educational use of copyrighted material is still permitted under the doctrine of fair use. However, a nonprofit's use would not necessarily fit the scholarly or educational use exemption. If your intended use exceeds these limits, check with legal counsel.**

 **For answers to the 16 most frequently asked copyright questions facing nonprofits, order NP9208-2, *Copyright Law: Your Rights and Responsibilities*. See back page to order.**

**1.2 Supreme Court Weighs In on Controversial Annuity Case.** In a terse two-statement order, the Supreme Court has nullified a Fifth Circuit decision that permitted a controversial antitrust case in Texas to proceed, putting hundreds of charitable gift annuities (CGAs) at risk. The Supreme Court directed the Fifth Circuit to reconsider the case in light of a federal law passed last summer that exempts CGAs from antitrust laws. (*NPA*, Aug. 97). Congress made the law retroactive with the express purpose of ending the Texas case. Charities in the case have repeatedly sought to have the suit dismissed, but the Fifth has Circuit refused.

★ **The legal battle has brought much needed attention to the thicket of state laws that charities must contend with if they issue CGAs. In response, the National Association of Insurance Commissioners has drafted a uniform law that would standardize many regulatory aspects among the states. The association will decide in June whether to send the proposed law to the states.**

 **Review NP9403-2, *Guidelines for Charitable Gift Annuities*, for more general information.**

## 2.Liability & Risk Management


**2.1 Fiduciary Duties Part I: Director's Failure to Inform.** Directors of nonprofit organizations owe the same fiduciary

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duty to their members that corporate directors owe their shareholders. That duty imposed liability on directors of a nonprofit health maintenance organization for failing to adequately protect their members' financial interests when the organization converted to for-profit status, a Maryland appeals court has ruled. In 1984, the nonprofit converted to a for-profit, stock corporation. In 1992, another company made a tender offer to purchase all outstanding stock, but the offer excluded some members who allegedly had failed to return certain documents when the initial stock was issued. Some claimed they never received the documents; others claimed they received no filing instructions or deadlines. A lower court dismissed their complaint, citing a 3-year statute of limitations, but the appeals court overturned the dismissal and remanded for trial, finding that the directors violated their duty of good faith to the former nonprofit members by failing to adequately inform them regarding the initial stock issue. *Shah v. HealthPlus, Inc.*, 696 A.2d 473 (Md.App. 1997).

 **The "business judgment" rule, which requires directors to apply their best business judgment and always act in the corporation's best interests, applies equally to nonprofit and for-profit directors. These duties are described in practical detail in NP9209-1, *The Legal Duties of Nonprofit Directors*. See back page to order.**

**2.2 Fiduciary Duties Part II: Minister's Sexual Misconduct.** The New Jersey Supreme Court has ruled that a church rector owes the same duty as a psychotherapist when engaged in a counseling relationship in which trust and confidence are imperative. Just like a pastoral counselor, a church rector owes a fiduciary duty, plus a duty of loyalty and a duty to exercise reasonable care and skill to parishioners. The case


involved a female parishioner who brought suit against the rector after he allegedly engaged her in a sexual relationship during counseling. *F.G. v. MacDonell*, 696 A.2d 697 (NJ 1997).

 This is just one “hot” legal issue that clergy and churches routinely face. NP9701-1, *Legal Hot Spots for Churches in the 90’s* summarizes many more.

### 3. Employees & Volunteers

**3.1 Refusal to Verify Employment Leads to Liability.** When a former employee of the Data Forms corporation applied for a mortgage loan, the mortgage company requested verification of his past employment. Data Forms refused to verify any aspect of his employment, allegedly in retaliation for the employee leaving the company. The mortgage company denied the loan, and the employee was forced to contract with another lender at a much higher interest rate. He then brought a tortious interference with contract claim against Data Forms. The court ruled in his favor, finding that the original loan was denied solely because Data Forms, with malicious intent, refused to verify his previous employment. *Labate v. Data Forms, Inc.*, 682 N.E.2d 91 (Ill.Ct.App. 1997).


**A conservative approach that many employers take when asked for a reference is to give nothing more than verification of salary. But here, the employer wasn’t even willing to do that—and eventually paid for it.**

 Review what you should or should not say in an employee reference with NP9306-1, *Updating Your Employment Application*. See back page to order.

**3.2 Get Along By Getting Along, Not by Arguing Disability.** The inability to get along with co-workers does not constitute an impairment of a major life activity under the Americans With Disabilities Act (ADA), and therefore cannot support grounds for a disability discrimination complaint under that law, a federal court in Minnesota has ruled. A fired employee brought the suit, claiming he was diagnosed with a major depressive disorder that caused him to commit offensive behaviors against his co-workers on the job. His company fired him for repeatedly violating its policies against violence in the workplace. The court said the company’s disciplinary actions and its eventual discharge of the employee did not constitute discrimination based on a mental disability.

★ Although accommodation might have improved this situation, the employee never requested any change in his work environment or responsibilities; therefore, he could

state no claim against the company for failing to reasonably accommodate his needs, even if he had proven a legitimate disability. *Breiland v. Advance Circuits, Inc.*, 1997 WL 580598 (D.Minn. 1997).


 The ADA requires employers, including nonprofits, with 15 or more employees to reasonably accommodate workers’ disabilities. For a summary of the ADA issues that nonprofits frequently face, order NP9109-3, *Basic Requirements Under the Americans with Disabilities Act*. See back page to order.

### 4. Tax-Exempt News & Issues

**4.1 Private Inurement Brings Down Club Members.** Variety Club Tent, a nonprofit that had raised funds through bingo games for handicapped and disadvantaged children since 1930, lost its tax exempt status last month when the Tax Court ruled part of its net earnings had inured to private individuals. The club initially leased space for its bingo games in a building owned by five men, two of whom were the club’s treasurer, and a club member. Then, the club put these two in charge of all its bingo operations. Shortly thereafter, the two men used \$94,000 in bingo receipts to make unauthorized building repairs and pay unauthorized compensation. The state charged the club with various criminal violations. Four years later, the IRS retroactively revoked the club’s exempt status, alleging that the amounts paid to the club’s attorneys during the criminal proceedings, plus the rental payments, and the amounts diverted by the two insiders all constituted private inurement. The Tax Court upheld the revocation, but not all the IRS’ allegations of inurement.

★ The court agreed the rental payments to the two insiders constituted private inurement because both men were “insiders” and could not show the rental payments were made on a fair market basis. Although the treasurer obviously had insider status the court also found the non-officer member exercised the same degree of control over the club through his operation of the bingo games, despite his lack of a formal position in the club.

★ As for the legal fees, the court said amounts paid to defend the individual were private inurement because the club’s board never approved them. But other legal fees paid to defend the club were permissible. It also ruled that the funds diverted by the two were not private inurement but instead, were punishable as theft or embezzlement.

 For help understanding the nuances of insider status, review NP9109-4, *The Essential Don’ts of Private Inurement*. See back page to order.

**4.2 IRS Says: “No Records; No Exemption.”** A veteran’s post has lost tax exempt status because it failed to keep proper financial and accounting records on its non-member transactions and because more than 80% of its income came from a gambling operation that was open to the public. The post also held a commercial liquor license and operated a restaurant and bar. The IRS said this made the group a

#### Nonprofit Alert®

8280 Greensboro Drive, 7th Floor, McLean, VA 22102-3807

(703) 761-5000 Facsimile: (703) 761-5023

E-mail: npa@gandglaw.com


Editor-in-Chief ..... George R. Grange, II

Editor ..... Sarah J. Schmidt

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business rather than an exempt organization. IRS TAM 9747003.

★ **IRS officials recently announced more audits of exempt organizations that run gambling operations. As in this case, the primary focus will be on UBIT and proper records.**

 **NP9104-1, *Records Retention Requirements*, provides helpful guidance to nonprofits regarding which records must be kept and when certain other records can be deleted.**

#### 4.3 *Standard Mileage Rates, Per Diem Increase for 1998.*

The standard mileage rate for charitable use of an automobile increases this year to 14 cents per mile, up from 12 cents a mile in 1997. The business rate also increases this year by one cent to 32.5 cents per mile. Daily per diem rates for high cost areas went up to \$180 this year, while the rate for all other areas increased to \$113 per day. IRS Rev. Proc. 97-58.

★ **Nonprofit employers may use these rates in establishing travel reimbursement for employees and in complying with tax withholding and reporting requirements.**

## 5. State Rules & Regulations

### 5.1 *Arkansas Exemption Depends on Use, Not Ownership.*

The Arkansas Court of Appeals has ruled that property owned by a church but mortgaged to the church's minister is eligible for state property tax exemptions. The minister originally acquired the property, then conveyed a tract to the church on which the church building is located. The tax assessor refused to grant the exemption, citing the minister as the "de facto" owner. But the appeals court said the property's use, not its ownership, determined exemptions. The property was used exclusively for church purposes; therefore, it qualified for the exemption. *Sue Phillips v. Mission Fellowship Baptist Church* (AR Ct.App. 12/10/97).

**5.2 *Florida Privacy Proposal Gaining Attention.*** This month, Florida's Constitutional Revision Commission debates changes to the state's constitution, including one that would prohibit the sale or rental of mailing lists. The proposal says Florida will "...protect natural persons against nongovernmental intrusion for commercial purposes into their private lives caused by the use of personal information not in the public interest."

★ **This may generate more state regulatory attempts to curtail the proliferation of mailing list transfers.**

### 5.3 *Virginia Taxes Solicitations by Out-of-State Nonprofit.*

The Virginia Department of Revenue has imposed sales taxes on religious materials sold in the state by a tax-exempt church organization based outside the state. Because the organization conducted solicitations through its employees in Virginia, the DOR ruled this was enough to establish a "nexus" between the organization and the state, which gave Virginia the right to impose its state sales taxes. VA P.D. 97-369.

## 6. Gifts & Fund Raising

### 6.1 *Corporate Sponsorship Payments Get Retroactive Break.*


The 1997 Taxpayer Relief Act included a provision that

### *NPA Highlight of the Month*

## Joint Ventures: Nonprofits Must Exercise Control

Nonprofits planning joint ventures with commercial corporations take heed: *the IRS is watching*. A high profile case, *Redlands Surgical Services v. Commissioner*, U.S. Tax Court Docket No. 11025-97, scheduled for a ruling from the U.S. Tax Court sometime later this year, is focusing attention on nonprofit joint ventures. Redlands Surgical Services is a nonprofit subsidiary of a California hospital corporation, for which the IRS refuses to grant exempt status. The IRS argues that charities may enter joint ventures with commercial corporations only if they "retain control over the income and assets necessary to carry out [their] charitable functions." If the arrangement is not structured so the charity retains control, then the venture creates impermissible private inurement, which is prohibited under §501(c)(3) of the tax code. Redlands has challenged the IRS's denial of its exempt status and filed extensive administrative documents with the Tax Court, outlining its control of the venture. Because the facts in this case are common to many nonprofit joint venture arrangements, the outcome is being closely watched among tax practitioners and nonprofit administrators alike.

★ **In a related development, the IRS has announced plans to intensify audits of exempt organizations that currently operate subsidiaries, partnerships, or joint ventures. An on-going audit program of exempt organizations with complex subsidiaries or legal structures has reviewed 95 organizations since 1991, and 79 others are still pending.**

 **If your organization currently relies or plans future reliance on temporary "leased" or "borrowed" employees, consult legal counsel to perform a focused human resources audit prior to signing a contract with the staffing agency, so your liability risks can be reduced. For a complete outline of all federal laws prohibiting discrimination in the workplace, review NP9312-1, *Avoiding Employment Discrimination in the Nonprofit Organization*. See back page to order.**

exempts from UBIT tax any sponsorship payments made to tax-exempt organizations by a corporation, even if the corporation's name or logo is used in acknowledging the payment. Now, IRS officials have announced they will apply that new tax break retroactively.

★ **This means the exemption will cover even those corporate sponsorship payments made before the Taxpayer Relief Act passed last year. The exemption does not apply, however, if there is an active or overt promotion of the corporation's services or products.**

**6.2 Bankruptcy Court Approves Reasonable Contributions.** A California bankruptcy court has ruled that charitable contributions are permitted under a bankruptcy plan, regardless of whether the contributions are sectarian or secular, so long as amounts are reasonable. The case started with a husband and wife's Chapter 13 bankruptcy petition that included as part of their repayment plan, \$470 per month in church tithes. The bankruptcy trustee objected, claiming the funds should be allotted to creditors instead. The court said some amount of charitable contributions are permitted, but only if they are allocated out of the debtors' living expenses. Here, the court said the debtors submitted expenses that were too high. Therefore, they could claim the charitable contributions only if they included them in living expenses and adjusted the total to a more reasonable amount. *In re: Andrade, Debtors*, No. 97-22762-A-13, 1997 Bankr. LEXIS 1659 (Bankr. E.D. Cal. 1997).

## 7. Executive Items of Interest

**7.1 Quote of the Month.** "NO ONE HAS POINTED TO ABUSES TO JUSTIFY THIS. IT'S REGULATION FOR REGULATION'S SAKE." — Terry L. Simmons, president of Charitable Accord, commenting on the proposed uniform law that would standardize state regulation of charitable gift annuities. (See related story, ¶1.2).

**7.2 Rebuttal of the Month.** "THE FUTURE ISN'T ALWAYS THE SAME AS THE PAST." — Jerry Fickes, chairman of the drafting committee of the National Association of Insurance

Commissioners, commenting on why a uniform state law is needed for gift annuities.

**7.3 Consider Joint Marketing With Commercial Product.** A survey taken during the recent holiday shopping period indicates Americans are strongly influenced by the philanthropic efforts of the stores where they shop. At least 54% of the respondents said they would shop at stores during the holidays that they knew had a policy of charitable giving.



**To consider the legal issues arising from such commercial co-ventures and other types of entrepreneurial activity order NP9110-1, A UBIT Primer for Nonprofits.**

**7.4 Year 2000: Excuse for Another Day Off?** Last month, *Nonprofit Alert* highlighted the problem nonprofits face in updating their computer systems to recognize the year 2000. Now, the Securities Industry Association, a Wall Street trade group, is proposing that Dec. 31, 1999 be declared a bank holiday so that financial institutions can have an extra day to fix last minute glitches. The SEC is considering the proposal. In the meantime, the SEC has required publicly-traded companies to describe their plans to deal with the problem and to disclose costs if they are "materially" significant.

★ **None of these proposals apply to nonprofits yet, but stay tuned. Congress has taken a keen interest, so the holiday proposal could eventually cover the nonprofit world.**

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Richard M. Campanelli  
Stephen M. Clarke  
A. Wray Fitch III  
James A. Gammon\*  
George R. Grange II  
Stephen H. King  
Nancy Oliver LeSourd  
Timothy R. Obitts  
Peter F. Rathbun  
Sarah J. Schmidt  
H. Robert Showers  
J. Matthew Szymanski  
Scott J. Ward  
Michael J. Woodruff  
Rebecca D. Zachritz  
\* of Counsel

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GAMMON & GRANGE, P.C.  
7th Floor, 8280 Greensboro Drive, McLean, VA 22102-3807

February 1998

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