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Nonprofit Alert®

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

Inside This Issue:

Court Removes Board Members for Abuses

A court may remove the board members of a nonprofit organization where there is evidence of significant abuses, but the court cannot reconstitute the board with its own appointees, writes the North Dakota Supreme Court in an instructive opinion that is a good legal primer for nonprofit board members.

Donald Larson founded and operated several religious nonprofit organizations in North Dakota, including the Family Life Services organization (FLS), which provided credit counseling and debt pooling for its Christian clients.

In 1996, a state court removed Larson and all the board members of FLS, finding that there were ongoing abuses with client funds and operating accounts.

Among the abuses: client funds were commingled with other funds and were used as part of FLS's operating income; Larson took money from FLS without board approval to buy his wife a car; and he made loans to two board members in direct violation of state laws prohibiting nonprofits from making loans to their directors or officers.

In addition to removing Larson and the board members, the court reconstituted the board with five to seven members and specifically required the replacement members to hold similar religious beliefs as the outgoing board. It was this last measure that Larson appealed to the state supreme court.

Without debating the findings of wrongdoing, Larson argued that the lower court's remedy was unconstitutional. The state supreme court agreed, finding that the lower court should've dissolved the organization and dismissed the board, rather than reconstitute it and specify theological beliefs for its membership. However, the supreme court let stand the part of the ruling that prohibited Larson from serving on the board again for five years. *State of North Dakota v. Family Life Services*, 2000 ND 166 (ND).

The lesson from this case: most states absolutely prohibit nonprofits from making loans to their directors or officers. Commingling of funds that are impressed with any kind of trust or third party obligation is a textbook violation of fiduciary duty. Personal use of nonprofit funds is flagrant private inurement and usually triggers intermediate sanctions.

➤**For a roadmap through this risky territory, order Nonprofit Alert® Memos, *Directors' Nonprofit Legal Duties,* and *Governing Responsibly by Nonprofit Board Members.***

Scouts Sue School District for Access

The Boy Scouts filed suit last month against the Broward County school board in Florida, alleging that they were illegally barred from using school property in retaliation for the Scout's ban on homosexuals. A total of 57 Scout troops and Cub Scout packs were prohibited from using school property under a new school board policy that was supposed to take effect December 17. The school board says the Scouts' ban on homosexuals violates a nondiscrimination policy covering the use of school property.

The Scouts say the policy isn't being applied equally to all groups but is being used to specifically target their organization because of their ban on homosexuals. The Scouts claim this violates their constitutional rights to free expression and equal access to public facilities. A similar incident also took place in New York City where the school chancellor barred schools from sponsoring most Scout activities or allowing the Scouts to recruit during school hours.

➤**These cases are significant to any nonprofit that serves a particular clientele and depends on the use of public facilities. If the school ban is upheld, any nonprofit that serves a single sex or a specific religious group, for instance, could be barred from using public facilities having a nondiscrimination policy in place. Watch Nonprofit Alert® for the outcome of these cases.**

Liability & Risk Management

The Check's In the Mail . . . But Where'd It Go?

Joan Ryan, a columnist for the *San Francisco Chronicle*, spent several weeks last summer touring Kenya. Shaken by the decimation and poverty she witnessed, she wrote an article describing how the drought had taken a toll on the cattle of the Samburu tribe. At the end of the article, she provided the address of a Kenyan charity where readers could send a $40 donation to buy a cow for a tribal family. The article generated more than $12,000 in donations, then "the good deed turned into a nightmare," wrote Ryan in a follow-up article. Numerous donors began calling with strangely similar stories. Their $40 checks were being intercepted before reaching the Kenyan charity and altered to read several thousand dollars more. One lady's check had been changed to $9,600 and made out to an office supply store in Virginia. Another man's check was altered to read $5,460 payable to an automobile company in New York. The State Department has now taken the case under investigation.

Such reports can discourage potential donors from giving to legitimate charities. To be proactive, encourage donors to research charities before they give. List your charity with an accountability group such as Guidestar (www.guidestar.org) or Ministry Watch (www.ministrywatch.com). To help

Fraternity Liable for $250,000 in Party Accident

Just because you plan an event at a restaurant or some other commercial establishment, you're still not free of liability for any risks that may occur during the event. A Creighton University fraternity learned that legal lesson the hard way: a civil court in Nebraska found Pi Kappa Alpha liable for $250,000 in damages sustained by a female student who was injured at a party sponsored by the fraternity. The fraternity booked the party at a local restaurant, thinking the restaurant was responsible for preventing underage drinking and for insuring its facilities were safe. At the party, the 19-year old student became intoxicated and fell through a cracked window after loosing her balance while seated in a booth. She sustained multiple injuries, including a serious concussion that left permanent brain injuries. The court found the student 40% liable for her own injuries because she had been drinking at the time of the accident. But the court held the fraternity 60% liable because she attended the party as a guest of a fraternity member.

If your organization sponsors events at locations other than your own facilities, contact your insurer to make sure your liability coverage includes tort risks from off-premises events.

Deacon's Police Hat Tops Cleric Collar

A church deacon who was also a state trooper cannot withhold information that a parishioner shared with him about an alleged criminal act, a New Jersey court has ruled, because the deacon acted in a dual role. The parishioner was allegedly involved in a shooting that left one person dead and another injured. The next day, the parishioner met with his pastor and indicated he wanted to surrender to police. The pastor then introduced him to one of the church deacons who also happened to be a state trooper. The deacon explained that he was a law enforcement official and advised the parishioner of his right to remain silent. The parishioner proceeded to confessed his role in the shooting to the deacon. At trial, the deacon/trooper refused to reveal what the parishioner said, citing the cleric-penitent privilege, but later shared the information with the prosecutor in the case. The parishioner was convicted but appealed, claiming his confession had been privileged. However, the court concluded the deacon was "performing a secular function as a law enforcement official," and the communication was not privileged. *State v. Cary*, 751 A.2d 620 (NJ 2000).

For more information about the legal implications of clergy as advisors, refer to Nonprofit Alert® Memo, *Clergy Confidentiality: When, What & To Whom Do I Speak?* See back page for ordering information.

Employees & Volunteers

Small Nonprofit Employers Shift to Quarterly Taxes

Many small nonprofit employers got a break in federal employment taxes this month as a new IRS initiative took effect. As of Jan. 1, employers that pay less than $2,500 in employment taxes each quarter of the tax year are relieved of making monthly federal employment tax deposits and may instead make their deposits on a quarterly basis. The IRS first instituted the monthly-to-quarterly break two years ago and received good responses from small employers across the board because it lessened paperwork and improved cash flow. This year, the threshold was raised from $1,500 to $2,500 to keep up with inflation and include many more small employers. The IRS estimates one million small businesses, including many nonprofits, will benefit.

$300,000 Price Tag For Criticizing Jury Service

It took a $300,000 penalty for one Oregon employer to realize jury service is a civic duty for both employees *and* employers. The case began when an employee took several weeks of leave for jury duty. When she returned, her employer had made significant changes to her job, including a new work schedule and meeting attendance. Her

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'supervisor criticized her for a lack of commitment and told her she probably wouldn't get a raise because she was absent so long. She quit two weeks later and sued for constructive discharge. The company argued that the employee failed to use the proper complaint process and didn't give her supervisors an opportunity to correct the workplace problems. The court ruled in the employee's favor, however, finding that her jury duty played a "substantial role" in the employer's decision to terminate her. As penalty, the court awarded her $300,000 in damages. *Halbasch v. Med-Data, Inc.*, No. 98-882-HU (D.C. OR, 2000).

A federal law known as the Jury Systems Improvement Act (JSIA) prohibits employers from penalizing employees who take time off for jury service. Also check your state laws, which may be even stricter and in some cases require employers to compensate employees for jury service.

New 2001 Mileage Rates: Deductions Increase

The standard mileage rate for business use of an automobile increases this year to 34.5 cents per mile, up from 32.5 cents last year. The rate for using an auto for medical or moving purposes increases to 12 cents per mile, up from 10 cents. However, the charitable rate remains unchanged at 14 cents per mile this year.

Interestingly, a survey by the business research firm BNA showed that 74% of the responding organizations met or exceeded the IRS standard rates for mileage reimbursements. (IRS Rev.Proc.2000-48)

Nonprofit Alert® Memo, *Expense Reimbursement for Volunteers and Employees,* explains exactly which travel expenses are reimbursable or deductible. See back page to order.

Tax-Exempt Issues

Nonprofit's Sale of Real Estate Produces UBI

A nonprofit educational institute must pay unrelated business income taxes on the profits it received from the sale of real estate lots to the general public, the IRS has ruled. The institute operates a conference center and sponsors a 9-week summer institute, featuring classes in art, music, dance, and theater. The institute also provides support to several permanent residents who live on its 750 acres, including police protection, garbage collection, and road maintenance. Plus, the institute operates a golf course, tennis courts and boating facilities for these residents. To increase the number of residents, the institute purchased 7.5 acres of land and subdivided

NPA Highlight of the Month

States Look to Internet for New Sales Taxes

Marketing analysts say Internet sales growth is beginning to slow, but with nearly $500 billion estimated in Internet transactions last year, state regulators know they're missing out on a huge revenue source. "If we don't act quickly and show Congress we're serious, we'll have a real problem," Illinois state Sen. Steven Rauschenberger, co-chair of a task force drafting model legislation, told an audience of key state legislators recently.

At least 30 states are currently considering ways to simplify their sales tax structures, making it easier impose sales taxes on Internet transactions. But first they must overcome some significant legal hurdles. The most restrictive hurdle—a three-year moratorium on Internet taxation passed by Congress in 1998—expires in October unless Congress acts soon. That has state regulators postulating about the possibilities for new Internet taxes. Rauschenberger says state and local governments must convince a largely unsympathetic Congress that e-businesses no longer need special protection that the moratorium provided, Reuters reports. Congress initially passed the moratorium to help fledgling e-businesses get off the ground and encourage more growth on the Internet. At the time, the Senate actually considered a broader bill that would have imposed a 6-year moratorium. Many of those supporters are still around, so state regulators must lobby hard to open the Internet to sales taxes now. Some of the sales taxes that the states could propose would apply to products and services offered by nonprofits via the Internet, such as books and other resources.

Opponents of e-taxes want the Internet to grow unfettered by tax burdens, but proponents say local governments are being deprived of crucial taxes while electronic commerce prospers. Moody's Investor Service calculates the possible e-sales tax revenue that states could collect by the year 2003 at nearly $10 billion.

Another legal hurdle that state regulators must cross is one handed down by the Supreme Court in a 1992 landmark case, which prohibited states from collecting taxes on catalog sales from entities located outside their borders unless the entities had some "presence" or "nexus" inside the state. Most cases since then have dealt only with physical "presence," so it will be new law to sort out whether and to what extent an e-presence is enough to justify the imposition of state sales taxes.

Rauschenberger says the model tax legislation that his task force has drafted would significantly simplify state sales tax codes so that the calculation and collection of sales taxes on Internet transactions would be as automatic as using a credit card. Determining which state sales tax to apply would depend on the buyer's address. He believes the plan is the best option for states to capture all the sales tax revenue they're now loosing, but without overburdening e-businesses or consumers.

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the property into lots, which it then sold to the public. The IRS considered this activity to be a trade or business not substantially related to the institute's exempt function; therefore, UBI taxes applied. The municipal services that the institute provided to residents did not produce UBI, however, because they were not a trade or business, the IRS concluded. IRS PLR 200047049.

Emailed Gift Receipt? IRS Says "Maybe"

The IRS has released a general information letter indicating it would "probably" accept a charity's gift receipt sent via email to a donor for purposes of substantiating gifts over $250 and/or for satisfying the quid pro quo disclosure requirements of the tax code. A taxpayer had requested an answer to the hypothetical question, noting that the IRS had not previously ruled on the issue or offered guidance. The taxpayer also asked whether a for-profit entity, which used the Internet to solicit contributions on behalf of various charities, could provide the required substantiation to donors. However, the IRS declined to answer that question, saying it was more suited to a private letter ruling

Stay tuned to see if the taxpayer re-submits the question for a private letter ruling. Meanwhile, review Nonprofit Alert® Memo, *Charitable Gifts: Receiving & Receipting*, for details about the substantiation requirements. See ordering information below.

State Rules & Regs

Legal Announcements Required for NY Foundations

A recently enacted state law requires private foundations incorporated in New York to buy legal notices in newspapers, announcing the availability of their annual tax returns, starting this year. The notices must state that a foundation's tax returns are available for public inspection at its main office and must be published in a newspaper designated by the clerk of the county wherever the foundation is located. The Wall Street Journal reports that foundation representatives and legal groups, including the state Bar Association, object to the law because it's too burdensome, especially when similar federal laws already provide easier and less expensive options for public access to the same information.

Watch this matter closely; if the law goes unchallenged, it may prompt other states to follow suit. Under federal law, foundations must also make their tax information "widely available" via the Internet or other sources. To learn more about the federal law see Nonprofit *Alert*® Memo, *IRS Disclosure Rules for Nonprofits.*

Executive Residences Now Exempt in Michigan

Charities in Michigan that provide residences for their executives just got a nice tax break from the state legislature. A new law now exempts from taxation any real and/or personal property owned by a nonprofit charitable institution so long as the property is used by the institution's chief executive officer as a personal residence. Residency on the property must be proven to be a condition of the executive's employment and documented. MI SB 801, signed into law as MI P.L. 309.