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Nonprofit Alert®

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

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Coming in 2004: Congress Questions In-Kind Donations

If your organization accepts in-kind gifts, take note: Senate Finance Committee Chairman Sen. Charles Grassley (R-IA) says his committee will consider "significant reforms" to the tax laws that cover charitable deductions for in-kind donations. Calling the issue a "rat's nest of problems," Grassley cited a recent GAO report that found wide discrepancies in the tax deductions donors claimed for these gifts in recent years. Donations of vehicles proved to be overvalued in many cases, according to the report, but Grassley believes the abuse extends to in-kind donations of real estate, art, and intellectual property.

Vehicle donations in 2000 accounted for about $654 million in lost tax revenue, reports the GAO.

Vehicle Donations

More than 700,000 taxpayers claimed deductions for vehicle donations in 2000, the GAO report found. All totaled, the deductions accounted for an estimated $654 million in lost tax revenue for the government, but charities recognized only a fraction of that amount, according to the report. The report speculates the administrative costs of selling vehicles, fundraising, and processing ate up significant charitable proceeds. Additional value was lost as charities sold most vehicles at auction for wholesale prices, the report notes.

GAO also examined 54 selected cases of vehicle donations made during 2000. In two-thirds of the cases, GAO found that charities received less *(continued on page 4)*

Quick Tax Tip: IRS Adjusts Charitable Deductions for 2004

The IRS has announced inflation adjustments to the amounts donors may deduct for charitable contributions when they receive something in return from the donee charities (i.e. quid pro quo gifts). In 2004, if a donor contributes $41 or more and receives goods or other benefits valued at $8.20 or less, then the contribution is fully deductible (for 2003, those amounts were $40 and $8, respectively).

Otherwise, the donor must deduct the value of these "quid pro quo" benefits from his/her charitable contribution to determine the applicable tax deduction. Under an alternate formula, the contribution is fully deductible if the donor receives goods or other benefits that have a fair market value of no more than 2% of the value of the contribution or $82, whichever is less (for 2003, that figure was $80).

Read the full IRS announcement here.

Liability & Risk Management

Hospital lacks enough control over joint venture to retain exemption, Fifth Circuit rules

The Fifth Circuit Court of Appeals has vacated a lower court's ruling and remanded the case for additional fact-finding to determine whether a charity hospital should lose its exempt status for failure to maintain control over the day-to-day operations of a joint venture with a for-profit partner. A 2002 summary judgment ruling from a lower court permitted the hospital to keep its exempt status (see NPA, Aug. '02). But the Fifth Circuit was troubled by several issues the lower court didn't address. The case raises difficult questions about how much control charities must retain in joint ventures and other business arrangements with for-profit partners.

Background

Since 1925, St. David's Healthcare System, based in Austin, TX, operated as a 501(c)(3). But in 1996, the hospital partnered with the for-profit Columbia/HCA Healthcare Corporation (HCA) in a deal that required St. David's to contribute all its assets in exchange for a 45.9% interest in the partnership. Two years later, the IRS audited the hospital and eventually revoked its exempt status. The IRS said St. David's participation in the partnership did not permit it to operate exclusively for charitable purposes and improperly allowed HCA to privately benefit from the arrangement.

> . . . a nonprofit's governing control in a joint venture may not be enough to sustain tax-exempt status when the venture partner is a for-profit entity . . .

St. David's challenged the revocation and won in a lower court. But that court did not focus on the day-to-day control as the Fifth Circuit did on appeal. Instead, the Fifth Circuit determined the partnership was controlled by a subsidiary of St. David's for-profit partner, HCA.

Lack of Control

St. David's held a position on the partnership's board of governors, but the court noted that the board's power was limited to making decisions on major management issues, not the daily operations of the partnership. Accordingly, the court determined that St. David's lacked authority over any management decisions that fell outside the small purview of the board.

St. David's also claimed that it maintained ultimate authority over the partnership's CEO, but the court said no evidence substantiated that assertion. The court pointed out that St. David's failed to discipline the partnership's CEO when he neglected the partnership's annual reports, which were required to document the amount of charity care the partnership provided. "If St. David's was in fact unable *(continued on page 3)*

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Joint hospital venture . . . . . (continued from page 2)

to enforce a provision of the partnership agreement dealing specifically with charity care, that raises serious doubts about St. David's capacity to ensure that the partnership's operations further charitable purposes," the court wrote.

The partnership agreement gave St. David's unilateral power to remove the partnership's CEO. It also vested St. David's with power to dissolve the partnership if questions arose over its charitable operations or its community benefit standards. The lower court was convinced these "safeguards" assured adequate control for St. David's, but the Fifth Circuit disagreed. St. David's representation on the partnership's board allowed it only to veto certain board decisions, not to control a majority of the board.

The court had "serious doubts" about St. David's ability to ensure the partnership's operations were charitable.

The Fifth Circuit interpreted the partnership agreement as allowing St. David's to dissolve the partnership only in limited circumstances, such as an unfavorable change in laws or regulations, but not if the charitable purposes or activities of the partnership changed. The court was also troubled by a non-compete clause in the partnership agreement, which it believed undercut St. David's power. Because the agreement prohibited St. David's from operating in the same market for two years after dissolution of the partnership, the court said St. David's unilateral power to dissolve was, in realty, ineffective since a dissolution would be "disastrous" for St. David's but would only be "slightly unpleasant" for HCA because it would continue to operate its nationwide health care business.

Read the Fifth Circuit's opinion.

Nonprofit Alert® Memo, *Subsidiaries & Nonprofit Affiliates,* provides more info on joint venture arrangements with nonprofits.

Impact on Nonprofits

The Fifth Circuit's decision suggests that a nonprofit's governing control in a joint venture isn't enough to sustain exempt status. The nonprofit's governing control must be extensive, and the nonprofit must also exercise sufficient operational control of the joint venture as well. Last fall, the IRS made public its resolution of a similar dispute with another hospital joint venture, which suggested that a nonprofit/for-profit joint venture is permissible as long as the nonprofit exercises at least equal governing control (i.e. 50% or greater) and appropriate protections are instituted to ensure that the joint venture furthers the nonprofit's charitable purposes. (See NPA, Sept. '03). Look for more guidance to emerge as the St. David's litigation continues. *St. David's Health Care System v. United States of America*, Nos. 02-50959, 02-51312 (5th Cir, 11/7/03).

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8280 Greensboro Drive, 7th Floor, McLean, VA 22102-3807 • (703) 761-5000 Fax: (703) 761-5023 • E-mail: npa@gg-law.com
Editor-in-Chief . . . . . George R. Grange, II Editor . . . . . Sarah J. Schmidt Assistant Editor . . . . . Stephen M. Clarke

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Nonprofit & Tax Exempt Issues

➥Has your organization considered Sarbanes-Oxley? Nonprofit Alert® Memo, *Annual Audits: Vital Risk Management,* includes an analysis of the law's impact on nonprofits.

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Charity boards behind the curve with Sarbanes-Oxley

Most nonprofits, according to a recent survey, have yet to implement any audit procedure changes in response to Sarbanes-Oxley, the federal law that mandates certain corporate accountability measures. Although the law does not directly apply to nonprofits, many experts have urged charity boards to adopt at least some of its standards to improve and legitimize their own governance processes. Since nonprofit directors are held to the same duty of care as their for-profit counterparts, ignoring the rising bar for reasonable care is not prudent.

The law passed in 2002 amid growing concerns over Enron, Worldcom, Arthur Andersen, and other corporate scandals. But only half the nonprofit executives surveyed in recent months had even heard of the law. Only 38% said their organizations had discussed the law and its implications. Only 20% reported their organizations had taken any action to change their governance policies in light of the new law. Of those 20% that took action, here's what they did:

- 24% adopted new or updated conflict of interest policies for their board members;
- 20% implemented new or updated procedures for internal financial controls;
- 17% drafted a code of ethics for their institutions and their executives;
- 16% formed audit committees; and
- 11% drew up standards of accountability and performance for board members.

The survey was conducted electronically among more than 300 nonprofit executives by Grant Thorton International, Inc., a business advisory firm.

In-kind donations . . . . . (continued from page 1)

than 5% of the value claimed by the donors on their tax returns as charitable deductions. For example, one taxpayer claimed a charitable deduction of $3,950 for his donation of a 1986 Toyota 4-Runner. However, the charity was only able to sell the car for $300 – less than 8% of the donor's claimed value. Once the charity subtracted the administrative costs of the sale, it was left with just $5.

While the GAO report focused primarily on vehicle donation programs currently operated by some 4,300 charities nationwide, Sen. Grassley's announcement suggests congressional scrutiny may be forthcoming for *all* types of in-kind donation programs. In-kind gifts now account for more than 30% of all corporate philanthropy, according to the Conference Board, a nonprofit market analysis group.

The IRS operates a compliance program to detect inflated gift valuations but it says the program hasn't been a priority because potential tax revenue yields are less than from what is collected from other noncompliance programs where the IRS devotes most of its resources.

Highlight of the Month

International trademarks: one application means less hassle

International protection of trademarks became much easier last fall when the U.S. officially joined the Madrid Protocol, an international treaty that permits trademark owners to register their marks in any of 60 member countries by the simple filing of one application. The treaty streamlines the international trademark registration process by making it less burdensome and more affordable, experts say.

If a U.S. trademark owner wants a mark registered internationally, only one application must be filed with the U.S. Patent and Trademark Office (PTO). After review in the U.S., the PTO sends the application to the World Intellectual Property Organization (WIPO) in Geneva, which then forwards the application to the selected countries.

Individual countries may accept or reject the application on their own terms, but the application provides a standard means of submission and review that previously was not available to U.S. trademark owners. The system also simplifies trademark management by allowing renewals and revisions (such as a name or address change) through one single procedure with the WIPO.

The Madrid Protocol – so named for Madrid, Spain – was first adopted in 1989. The United States didn't accede to the treaty until last year, however. President Bush signed the bill in August, and it took effect on Nov. 9, 2003.

Although the Madrid Protocol standardizes the paperwork involved in registering international trademarks, it does not standardize the filing fees. For example, the WIPO charges a filing fee of 73 Swiss francs ($47 U.S.), but 38 member countries currently exercise their right under the Madrid Protocol to set their own fees, which vary significantly.

If your organization conducts international operations, consider registering your trademarks internationally. Contact Kenneth Liu of Gammon & Grange, P.C. at (703) 761-5000 (x131) for a free initial consultation to develop the most efficient and effective international trademark and/or branding strategy.

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