



# Nonprofit *Alert*®

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

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## Nonprofit Overview

### *Court Rejects IRS Claim of Private Inurement*

In a closely watched case with significant implications for nonprofits nationwide, the Seventh Circuit has overturned the U.S. Tax Court's decision to revoke United Cancer Council's (UCC) exempt status as a 501(c)(3). The Court firmly rejected the IRS's theory that the charity engaged in illegal private inurement because it entered a contract that benefited a fundraiser more than the charity itself. Last year, the Tax Court upheld the IRS's decision to revoke UCC's exemption because of its contractual relationship with a professional fundraising firm. The Tax Court ruled that UCC gave the fundraiser too much control over its internal finances and management (resulting in over 90% of the funds UCC raised going to the fundraiser). But the Seventh Circuit found this was merely an unfavorable contract for UCC—one that UCC perhaps shouldn't have entered, but not one that created private inurement worthy of revoking a tax exemption. In a terse scolding, the Court said the private inurement provisions are "not to empower the IRS to monitor the terms of arm's length contracts..." The Court also rejected the IRS's "facts and circumstances" test to determine whether the fundraiser could be an insider, saying such a test would make the tax status of charitable organizations "a matter of the whim of the IRS." *United Cancer Council v. Commissioner*, No. 98-2181 & 98-2190, (7th Cir., 2/10/99).

★ **However, the Seventh Circuit left open the narrow possibility that UCC may have conferred an illegal private benefit on the fundraiser, depending on whether the arrangement was egregiously favorable to the fundraiser at UCC's expense. If so, loss of exempt status could still result, but in the absence of an insider, such illegal activity will be more difficult to prove. The Court then remanded the case to the Tax Court to settle this issue of private benefit.**

 **The lesson for your organization: always put large contracts with third parties, especially fundraising contracts, through an extra level of scrutiny before board approval. Get competing bids if possible; check out the deals that other customers are getting; or consider an outside consultant's opinion as to the fairness of a proposed deal.**

### *Investigation of Alleged Pyramid Scheme Heats Up*

Investment vehicle or fraudulent scheme? That's what regulators are asking about the Greater Ministries International Church (GMIC), based in Tampa, Florida. GMIC reportedly accepts financial "gifts" from supporters, then invests the money in gold and diamond mines in Liberia with the promise of doubling the "gifts" it repays to supporters. Many participants claim they've received significant returns, but regulators in at least three states are not convinced. Attorneys General in Pennsylvania, Ohio, and California have issued cease and desist orders, and this month, one of GMIC's leaders goes on trial for 15 counts of fraud, racketeering and theft. A federal grand jury has also convened to look into GMIC's fundraising tactics after the Colorado bank where GMIC reportedly deposited much of its funds was closed last year by the FDIC for insolvency. Some state regulators worry that GMIC may rival the Foundation for New Era Philanthropy, a nonprofit whose collapse in 1995 led to millions in losses for charities that invested heavily with the organization, only to discover it was merely a pyramid scheme.

 **The Tampa Tribune is following the GMIC story closely. For the latest developments, go to their web site: [www.tampatrib.com](http://www.tampatrib.com).**

## Liability & Risk Management

**Accidents on Leased Property: Who's Liable?** An Ohio church narrowly escaped \$25,000 for injuries sustained by a woman who slipped and fell on a rug as she left the church after voting on election day. Using a standard contract that the county prepared, church officials leased a portion of the church as a polling place. The lease specified that the county would maintain liability insurance for any injuries that might occur to voters during polling. A trial court ruled both the church and the county were each 50% negligent for \$50,000 in damages owed to the injured woman. But because the lease required the county to carry insurance, the court said the county should indemnify the church for its share of the negligence award, plus pay all the church's attorney fees and costs. The county appealed, arguing the lease contained no specific indemnification language, but the appeals court said the reference to liability insurance indicated the board intended to "insure any loss related to its operations on election day." *McCloy v. Hamilton County Bd. of Elections*, 1998 OH App. LEXIS 5761 (OH Ct.App. 1998).

★ **Because the county had prepared the lease, the court strictly construed its ambiguity regarding liability against the county. Another court might not have read the lease so favorably for the church, however, since property owners arguably have a public duty to maintain safe premises.**

➔ **The message here: carefully review all contracts and leases your organization enters, paying special attention to liability and indemnity provisions covering your facilities and/or services.**

### Private Citizen Can't Force Nonprofit Disclosure

The disclosure rules found in §6104 of the tax code do not give private individuals authority to compel public inspection of a tax exempt organization's tax returns, the Second Circuit has ruled. Those rules only give such authority to the IRS Commissioner, the court says. The plaintiff in the case had attempted to access tax returns at two college foundations in New York. She wrote to the foundations indicating her intention to visit and personally review their tax records, but both foundations refused access. She then filed suit, citing the disclosure rules. A lower court ruled in the foundations' favor, and the Second Circuit upheld, finding that the disclosure rules do not afford a private cause of action nor confer any rights on private plaintiffs against exempt

organizations. *Schuloff v. Queens College Foundation, Inc., et. al.*, No. 98-7466 (2nd Cir, 1999).

★ **This ruling is especially compelling in light of pending IRS regulations implementing new disclosure rules soon. The rules were issued three years ago (NPA, Sept. '96), but the IRS has encountered long delays in finalizing them because they were recently expanded to cover private foundations.**

➔ **The new rules require charities to provide copies of their tax returns upon request or otherwise make them available through such means as the Internet. A special section in NP9608-1, *Avoiding the Snares of Intermediate Sanctions* addresses the disclosure rules. See back page to order.**

## Employees & Volunteers

### COBRA Bite Enlarges Under Final Regulations

Last month, the IRS released final regulations that reflect recent statutory changes and court rulings on COBRA laws. The regs cover group health plans maintained by all employers, including nonprofits, with at least 20 employees. The regulations were effective immediately. They include these important revisions:

- Prevention of COBRA termination solely because a beneficiary had other health coverage prior to electing COBRA.
- Elimination of the rule that permitted health plans to offer only the option to elect continued coverage for core health care. Now, if the plan provides non-core health care (i.e. vision and dental coverage) to its regular beneficiaries, these same benefits must be offered with COBRA.
- New rules for determining whether the small-employer exception applies (i.e. less than 20 employees) and whether part-time employees are counted for purposes of meeting the minimum requirement. IRS Reg. §54.4980B; T.D. 8812 (*Federal Register*, 2/2/99).

➔ **NP9102-5, *COBRA Group Health Insurance* provides a helpful summary of COBRA requirements for employers. See back page to order.**

### Off to Work We Go, While Tax Deductions Bestow

In 1997, Congress liberalized the definition for a home office, making it easier to claim a tax deduction, but left open the issue of claiming commuting expenses under this expanded provision when workers were required to travel away from their home offices. Now, the IRS has ruled that home office workers can claim a commuting expense deduction just the same as before the 1997 changes, provided they meet the principal place of business test. The IRS also expanded the deduction for temporary employees if their jobs are realistically expected to last, and do in fact, last one year or less. IRS Rev. Rul. 99-7.

➔ **If you have employees who work from home, give them copies of NP9412-1, *The Home Office Deduction for Nonprofit Workers*. See back page to order, and ask about discounts for multiple copies.**

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## Tax-Exempt Issues

### **Consolidated Reporting: An Issue of Control**

Nonprofits that operate subsidiaries may have to alter their financial reporting if a new proposal under consideration by the Financial Accounting Standards Board (FASB) is adopted. The proposal would require “parent organizations” to consolidate reporting for each entity they control, meaning the financial status of all subsidiaries would appear on the parent’s financial statement. “Control” is defined as the “ability to direct the policies and management that guide the ongoing activities of another entity so as to increase benefits and limit losses.” A parent organization is presumed to control an entity if it has a majority voting interest in electing or appointing that entity’s governing body. FASB Rev. Statement of Position, 12/10/98.

★ **This proposal could mean significant reporting and accounting changes for nonprofits that operate subsidiaries, like church schools, hospital fitness centers, or university bookstores. Ask your accountant to keep you posted on this proposal and what it could mean for your organization.**

➡ **Parent-subsidiary relationships involving nonprofits can be complex. Sort through the complexities with NP9304-1, *Organizing Nonprofits and Their Subsidiaries*. See back page to order.**

### **“Artful” Sale by Nonprofit Avoids Tax Problems**

A nonprofit social club owned and exhibited an art collection but had no idea of its value until it was appraised. It turns out that one painting was extremely valuable, so the club decided to auction the piece and use the proceeds to renovate club facilities. Typically, such a sale would raise questions about taxable unrelated business income. But in this case, the IRS said the sale would not be taxable because the art was central to the nonprofit’s exempt function, namely providing dining facilities for its members. Since the art was ordinarily used in the nonprofit’s charitable function, and since the proceeds from the sale would be spent entirely on the nonprofit’s facilities, the IRS ruled the sale was tax free. IRS LTR 9844012.

### **Charitable Registration Just Got One Step Easier**

For years, tax exempt organizations cried out for a common registration form to meet state charitable solicitation requirements, but it wasn’t until 1997 that state regulators finally began accepting such a document. Only 20 states accepted that first common form. (NPA, Mar. ‘97). But now, the National Association of State Charities Officials has revised the form, making it acceptable in 32 states.

➡ **The new form can be downloaded from a web site at [www.nonprofits.org/library/gov/urs](http://www.nonprofits.org/library/gov/urs). It is also available for a small shipping fee from the National Federation of Nonprofits, (202) 347-0929.**

## **NPA Highlight of the Month**

### **Wealthy Donors Show Interest, But...**

## **IRS Cautions Against Split-Dollar Insurance**

Charitable reverse split-dollar insurance—it’s a novel approach to collecting charitable contributions and providing donors with tax benefits that might not otherwise qualify as deductions. Popularized by a California company, InsMark, Inc., it’s often sold as a product called the Charitable Legacy Plan. Under a typical plan, the donor makes an unrestricted “gift” to a preferred charity. The “gift” is then used to pay life insurance premiums for the donor’s policy, or third party policy which names the charity as a beneficiary. When the donor dies, the charity collects a portion of the insurance proceeds. In the meantime, the donor deducts all the “gifts” it makes to the charity, even though they’re used merely to pay the insurance premiums. It’s that last twist that has the IRS taking note. Marcus Owens, Chief of the IRS Exempt Organizations Branch, says, “We believe some of these plans are abusive tax shelters...nothing more than a scheme to create deductions where none existed.” If that’s the case, then donors and the charities that participate in such plans may be in jeopardy if the deductible dollars are used to create a private benefit. The IRS is especially concerned that the plans allow donors too much flexibility in manipulating policies for their own benefit, rather than for charity.

★ **The Wall Street Journal reports the arrangements are especially attractive to wealthy donors looking for ways to limit their estate taxes. But the IRS has opened an inquiry into these plans, so far questioning officials in at least one participating charity, plus various donors. The IRS also reportedly rejected a recent application for exempt status from an organization that intended to finance its operations through these arrangements. In addition, two recent bills introduced in Congress would remove any doubt that split-dollar insurance plans are prohibited as tax avoidance measures under the tax code. H.R. 572, introduced by Rep. Gerald Kleczka (D-WI), prohibits a tax deduction for such plans and classifies expenditures made under the plans as private benefit, which would adversely affect a charity’s exempt status. H.R. 630, introduced by Rep. Bill Archer (R-TX) and Rep. Charles Rangel (D-NY), goes a step further and imposes excise taxes on charities that enter these plans.**

➡ **The National Committee on Planned Giving, based in Indianapolis, has issued a report on these questionable plans, calling them at best, “high risk ventures” that “may endanger the tax exempt status of charities.” To read more about the report, visit the Committee’s web site at [www.ncpg.org/charitablepaper.html](http://www.ncpg.org/charitablepaper.html).**

## State Rules & Regs

### ***Kansas DOR Does Double Play on Athletic Groups***

The state Department of Revenue has handed down two opinions, one favorable to nonprofits and one not so favorable. The first case exempted a church athletic foundation from collecting sales taxes on the fees its members paid to participate in events the foundation sponsored. The other case required a youth baseball program to collect sales taxes on candy sold as a fundraiser. No. P-1998-195 & P-1998-189.

### ***Michigan Church Retreat Not Taxable Property***

The state tax tribunal has removed a property tax assessment on a spiritual retreat owned by the Archdiocese of Kalamazoo. Local authorities argued the retreat was only recreational, but the Archdiocese showed it was often used for spiritual services, although it was also used for personal retreats. This qualified it as exempt property, because it was consistent with the Archdiocese's overall charitable mission. *Archdiocese of Kalamazoo v. Ganges Township*, No. 236852 (1998).

### ***Missouri Exempts Day Care Equipment From Tax***

The Missouri State Tax Commission has ruled that equipment used at a nonprofit day care center is exempt from personal property tax because the center operates on a purely nonprofit basis and the property is used exclusively for charitable purposes. *Mid Rivers Day Care v. Zimmerman*, No. 97-32637.

### ***North Dakota Lawmakers Defeat Local Option Bill***

The state legislature has rejected a bill that would have allowed cities and municipalities to impose special property assessments and taxes on charitable organizations. The bill had ample legislative support, but failed to garner the necessary floor votes. H.B. 1051.

**Quote of the Month.** "I DON'T KNOW HOW IT WORKS, AND I DON'T WANT TO KNOW HOW IT WORKS." — Merle Calkins, a Greater Ministries supporter, commenting in *Christianity Today* on reports that the organization is nothing more than a typical pyramid scheme. See related story, page 1.

**Dial 1-877 for Nonprofit Help From IRS.** Earlier this year, the IRS debuted a new toll-free telephone number for tax-exempt questions. The number rings into the IRS Service Center in Cincinnati, which now handles all exempt status applications.



**The new toll-free number for tax-exempt questions is (877) 829-5500. The exchange is so new that many phone systems may not recognize it yet. If that happens, IRS officials say call an operator and ask to be connected directly.**

**What's Your Salary? University Study Wants To Know.** The Nonprofit Management Institute at Arizona State University has launched a national survey to collect data on executive salaries at charitable organizations. The information is confidential and will be used for research purposes only. If you participate, the university will send you a free copy of the results.



**Participate in the study by completing the online survey at [http://129.219.153.130/surveys/nonprofit\\_survey.html](http://129.219.153.130/surveys/nonprofit_survey.html).**

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