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# Nonprofit Alert®

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

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## Intermediate Sanctions:

## *IRS Issues New Guidance on Enforcement*

The IRS has just released more guidance on how it will enforce the intermediate sanctions law, filling a void left in the legal landscape since the first set of temporary rules were issued in 1998.

The intermediate sanctions law makes nonprofit "insiders" personally liable for any improper benefits they receive from the nonprofits they serve. But the IRS supplements that law with regulations designed to give further guidance on enforcement issues and various legal scenarios that result.

The earlier rules left practitioners speculating about a number of enforcement scenarios. The new guidance sheds light on several areas, including material compensation and consulting contracts.

For example, the new regs say fixed payments made to consultants and third parties entering fundraising or other service contracts with nonprofits, won't be subject to the intermediate sanctions law under their first contract.

However, incentive payments or substantive contracts with the same party (even if the terms are the same) will be subject to intermediate sanctions.

This provision was included in direct response to the 7th Circuit's 1999 ruling in the *United Cancer Council* case. (See *NPA*, Mar.'99).

The new guidance also states that a manager may avoid personal liability by relying on the reasoned opinion of a lawyer, CPA, or independent valuation expert. The new rules do not, however, significantly address the issue of revenue-sharing, (i.e., where payments to an insider are based on revenues).

That practice has been a topic of much concern since the first set of rules were released, but practitioners must still await further guidance from the IRS on this key issue.

Although "temporary," these regulations have the effect of final regulations for purposes of compliance, which means charities may need to re-evaluate their compensation plans in light of the new guidance. IRS NPRM Reg 246256-96, TD 8920.

➢ Order Nonprofit Alert® Memo, *Intermediate Sanctions Law,* to better understand how the rules affect your organization.

## *Protecting Donor Privacy*

It's always been an issue of concern, but donor privacy takes on added urgency now that personal data is so widely available on the Internet, often without an individual's authorization or knowledge. How should nonprofits respond? The Association of Professional Researchers for Advancement has drafted instructions for gathering data about potential donors and how to safeguard that data once collected. The group recommends that charities inform all donors and potential donors about their data collection processes, informing them up front

thattheinformation will be used to solicit contributions.

➢**Free copies of the position paper, *Privacy and Advancement Research,* are available at the association's web site (http://www.aprahome.org) or from the association at 414 Plaza Dr., Suite 209, Westmont, IL 60659; (608) 655-0177.**

### ➢➢➢*Tax Deductions Increase* ≺≺≺

The numbers are in: revised IRS statistics for charitable deductions claimed in 1998 (the latest year for which th numbers are available) put the total at $109.2 billion—a full 10% increase over 1997 stats, which came in $99.2 billion. A total of 27.1% of individual taxpayers claimed charitable deductions in 1998, making this th highest amount recorded for the decade. The average amount they claimed: $3,228. The IRS data is compile in the *Statistics of Income Bulletin*, available for $22 from:Superintendent of Documents, U.S. GPO, P. O. Bo 371954, Pittsburgh, PA 15250-7954.

## Liability & Risk Management

### *Baseball Team Can't Control Volunteer's Foul Play*

The Illinois Supreme Court has relieved a Little League baseball team of liability for the criminal acts of its manager and assistant coaches that occurred during a 1990 tournament game. All the individuals were volunteers at the time of the incident. During the game, the manager and two assistant coaches attacked the first base coach on the opposing team, causing severe injuries that hospitalized him for five days. A separate cause of action against the offenders resulted in a default judgement, but when the injured coach was unable to collect damages, he sued the team. A lower court awarded the coach $632,000 and $125,000 for his wife, but the Supreme Court overturned the verdict, finding that the baseball team had no affirmative duty to protect the opposing coach against a criminal attack. The court said there was no evidence to suggest that the three offenders would perpetrate such an attack or that any of them had violent propensities. The coach argued that the team should have controlled the three offenders, but the court said the master-servant relationship dictates only that the master have the *ability* to control the servant, not that the master actually restrain the physical abilities of the servants. No other means of control, such as termination of employment or discipline, was available since the offenders were all volunteers. The team did not have any "inherent economic leverage or control" in this case because of the volunteer arrangement, the court concluded. *Hills v. Bridgeview Little League Association*, No. 87895 (IL SupCt, 2000).

**Nonprofits can be held liable for the acts of their volunteers just as if the volunteers were actually employees acting within the scope of their duties. Learn more with Nonprofit Alert® Memo, *Managing Volunteers: Risks & Rewards*. See back page for ordering information.**

### *Bishop Estate Trustees Settle for IRS Sanctions*

Five trustees of the Bishop Estate Trust, one of the wealthiest charities in the nation, have accepted an undisclosed amount in IRS penalties levied against them under the intermediate sanctions law, according to a press release issued through their attorneys. According to the *Honolulu Star-Bulletin*, each trustee paid an excise tax of about $40,000. The agreement is part of a settlement worked out in Probate Court, which enables the trust to receive approximately $14 million in settlement proceeds.

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The court got involved after the IRS and the Hawaii Attorney General found egregious acts of private inurement and private benefit by the trustees, including kickback schemes and lucrative contract awards that benefited the trustees and their relatives. (*NPA*, Nov. '98). Most of the trustees were removed from their positions in 1999 and replaced by court-appointed interim trustees. The IRS threatened to revoke the trust's exempt status, but instead reached a closing agreement conditioned on the removal of the trustees. At a net worth of approximately $10-billion, the Bishop Estate Trust operates with a single beneficiary, the Kamehameah Schools for students of native Hawaiian ancestry.

**This brings to a close the long saga of the Bishop Estate Trust, illustrating some of the worst ever examples of private benefit and conflicts of interest by trustees of a public charity.**

### *Securities Firm Pays $800,000 for its New Era Role*

Prudential Securities will pay an $800,000 fine to the Securities and Exchange Commission (SEC) for its role in the New Era Philanthropy scandal, which unraveled in 1995 when federal investigators uncovered a high stakes Ponzi scheme that cheated hundreds of charities out of more than $350 million in investment dollars. Prudential has already paid an $18-million fine to settle lawsuits filed by the federal bankruptcy trustee who handled the New Era case. The separate charges by the SEC alleged Prudential failed to properly supervise the broker who handled the New Era account. The SEC also levied a $64,586 fine against the broker (who is now retired) and a $15,000 fine against the supervisor who oversaw the broker's work at Prudential. The SEC said the broker "willfully aided and abetted" the New Era scandal, and his supervisor "missed significant red flags."

## Employees & Volunteers

### *Permanent Educational Assistance Plan Introduced*

The tax exclusion for employer-provided educational assistance programs would become permanent if new legislation introduced by Sens. Charles Grassley (R-IO) and Max Baucus (D-MT) is passed. Grassley, who chairs the powerful Senate Finance Committee, said the measure "encourages employer investment" by "raising workforce productivity and making businesses more competitive." The provision was first made law with the Revenue Act of 1978, but with a conditional expiration date. Since then, Congress has renewed it ten times. Grassley and Baucus say it's time to make the measure permanent. The current law, which allows employers to provide up to $5,250 per year in tax free tuition assistance, is set to expire at the end of this year. S. 133.

**The Senate Finance Committee concluded hearings on the matter in mid-February. Stay tuned for the final outcome of this legislation. In the meantime, turn to Nonprofit Alert® Memo, *Employee Educational Assistance Programs*, for a summary of these valuable employee benefits. See back page to order.**

### *Contract Slip Leads to Reinstatement of Drug User*

Settling a split among federal circuit courts, the Supreme Court has ruled that courts must enforce an arbitrator's decision so long as it does not conflict with the law. The ruling stemmed from a wrongful discharge case filed by a truck driver who was fired after testing positive for marijuana a second time. He filed a grievance with an arbitrator, claiming his employer lacked just cause for his termination as defined under a collective bargaining agreement. The arbitrator agreed, and held that suspension without pay would have been adequate discipline. The employer appealed on grounds that reinstating a known drug user, particularly in a safety-sensitive position like trucking, violated public policy. The Fourth Circuit upheld the arbitrator's decision, however, so the employer appealed to the Supreme Court. In deciding the issue purely on contractual grounds, the Supreme Court said the arbitrator's decision would stand because neither the collective bargaining agreement, nor the company's own drug policy, nor any federal regulations expressly required employees who fail drug tests to be fired. Since all those documents had the primary purpose of rehabilitating drug users, not firing them, the Court said the arbitrator's decision was not against public policy. *Eastern Associated Coal Corp., v. Mine Workers*, No. 99-1038 (2000).

**The lesson here: if you intend to fire employees for positive drug tests, then your organization's substance abuse policy should be carefully drafted to state exactly that (i.e. employees who test positive for drugs will be terminated, not *may be* terminated). Whether a dispute then goes to arbitration or litigation, the policy will provide an unambiguous rule for the arbitrator or judge to enforce. Review termination options and other scenarios in Nonprofit Alert® Memo, *Substance Abuse Prevention,* for details. See back page to order.**

## Tax-Exempt Issues

### *Rental Income From Broadcast Tower Makes UBIT*

The IRS has decided that rental income, which an exempt organization collected by leasing space on its broadcast tower, constitutes unrelated business income (UBI). The broadcast tower sits on property owned by the organization. Because the tower is large enough to support additional radio antennae beyond those that the organization uses for its own purposes, the organization maintains a long-term lease for the additional space and right of way for the installation, operation, and maintenance of another entity's equipment. The organization collects monthly rent from the other entity. In 1998, the IRS issued an initial ruling (PLR 9816027) on this same matter, finding that the rental income was not UBI because the broadcast tower was permanently affixed to the organization's real estate, which made it real property. Under §512 of the tax code, rental income from real property is excluded from the definition of UBI. A review of the same case now produces a different outcome, however, with the IRS deciding that the broadcast tower is really *personal property*, which does not fall within the §512 exclusion. Under this analysis, the IRS now says the rental income is taxable UBI for the exempt organization. IRS PLR 200104031.

**For more information, order Nonprofit Alert®Memo, *UBIT Primer for Nonprofits*. See ordering information on page 4.**

## *NPA Highlight of the Month*

# Contractor v. Employee:
# *Incorrect Classification Could Cost Big Bucks*

It cost Microsoft nearly $100 million and eight years of litigation to fix its mistake. Time-Warner paid $5.5 million in a similar case. What "mistake" could be so costly? Misclassifying workers as independent contractors when either the IRS or Department of Labor say they should, in fact, be categorized as employees with all the attendant benefits and tax consequences.

In the Microsoft case, the IRS first raised the issue when it reclassified some 12,000 "freelancers," as employees. This created significant tax liabilities for Microsoft because it hadn't paid any employment taxes on those workers. The IRS action led to a lawsuit by two of the freelancers who claimed they'd been denied employment benefits (including valuable stock options). The 9th Circuit finally resolved the case in favor of the freelancers. Microsoft appealed, but the Supreme Court refused to hear the case, effectively upholding the 9th Circuit ruling.

In Time-Warner's case, it was the Department of Labor that initiated legal action against the company for its misclassification of "freelancers" and "temporary" workers. Rather than litigate the matter as Microsoft had done, Time Warner agreed to an expensive settlement without admitting liability.

The costly nature of these lawsuits stems from the cumulative damages that must be paid, including back taxes, interest and penalties, unpaid overtime, and retroactive employee benefits like health care coverage and retirement or pension plans. Although these cases involved big international corporations, the risk is no different for tax-exempt organizations. Proper worker classification comes down to a question of control: how much control does the employer exert over the worker? The more control, the more likely the worker is an employee. Factors to consider in evaluating control, according to the IRS, are: (1) skill levels; (2) where the work is performed; (3) how long the work relationship has existed; (4) method of compensation; (5) who provides tools or resources needed to do the job; (6) work schedules; and (7) exclusivity of the relationship.**As nonprofits turn to outsourcing and alternate contracting arrangements to reduce staffing costs, the risk of worker misclassification increases exponentially. Assess and manage the risk smartly with tips from Nonprofit Alert® Memo, *Independent Contractor v. Employee.* See ordering information on the back page.**

### *Cash Gifts Are Great, But Donor Must Substantiate*

The Tax Court has upheld an IRS ruling that denies more than $12,000 in charitable contribution deductions to an Ohio man who claimed he gave contributions in cash to various charities to insure his anonymity. At trial, the donor introduced his savings account register that showed frequent withdrawals of cash that he said he gave to charitable organizations. Also introduced as evidence was a sheet of paper on which the donor kept a tally of other gifts he made to a church. The donor admitted calling a local IRS office and asking for advice on claiming deductions. When told he would have to substantiate his claimed charitable contributions, the donor reportedly told the IRS agent, "Well, I'm going to try anyway and see what happens." The court ruled that his documentation was not acceptable. Instead, the donor should have substantiated the date, amount and recipients with either a canceled check or receipt from the donee, the court concluded. *Stanley Joseph Jennings v. Commissioner*, T.C. Memo 2000-366.

**Although donors are ultimately responsible for substantiating their own charitable deductions, it's good practice for organizations to issue charitable receipts. Read more about the receipting rules in Nonprofit Alert® Memo, *Charitable Gifts: Receiving & Receipting.***

## State Rules & Regs

### *New Jersey Awards Worker Comp to Camp Trainee*

A New Jersey appellate court has ruled that a 14-year old counselor trainee at a summer camp, "who performs service for an employer for financial consideration," is eligible to receive worker's compensation. The ruling overturned a state Worker's Compensation Division ruling that initially denied worker's comp to the girl because she worked at a free day camp along with other volunteers. The appeals court found, however, that she was paid for one day of participation in a training program and all her camping expenses were reimbursed. The pure "volunteers" at the camp did not receive such payments. *Kraivanger v. Radburn Association*, No. A-438-99T2 (NJ Super.Ct., App.Div., 2000).

**Be careful not to inadvertently convert volunteers into employees by gratuitously providing even small employee-like benefits. Compare other scenarios in Nonprofit Alert® Memo, *Expense Reimbursement for Volunteers & Employees.* Ordering info appears at right.**

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